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EDITOR'S NOTE

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No. 86-279-CFX
Status: GRANTED

Title: Basic Incorporated, et al., Petitioners
v.
Max L. Levinson, et al.

ocketed:
August 23, 1986

Court: United States Court of Appeals
for the Sixth Circuit

Counsel for petitioner: Madsen, Henry Stephen, Golub, William W., Sternman, Joel W.

Counsel for respondent: Cross, Wayne A.

Entry	Date	Note	Proceedings and Orders
1	Jun 10 1986		Application for extension of time to file petition and order granting same until August 24, 1986 (O'Connor, June 10, 1986).
2	Aug 23 1986	G	Petition for writ of certiorari filed.
3	Aug 23 1986		Appendix of petitioner Basic Inc., et al. filed.
4	Sep 22 1986		Brief of respondents Max L. Levinson, et al. in opposition filed.
5	Sep 24 1986		DISTRIBUTED. October 10, 1986
6	Oct 1 1986	X	Reply brief of petitioners Basic Inc., et al. filed.
8	Oct 14 1986	P	The Solicitor General is invited to file a brief in this case expressing the views of the United States. The Chief Justice OUT.
9	Jan 20 1987		Brief amicus curiae of United States filed.
10	Jan 21 1987		REDISTRIBUTED. February 20, 1987
11	Feb 23 1987		Petition GRANTED. The Chief Justice OUT. *****
13	Mar 4 1987		Order extending time to file brief of petitioner on the merits until April 30, 1987.
14	Apr 3 1987		Record filed.
15	Apr 3 1987		Certified copy of original record and proceedings, 2 boxes, received.
16	Apr 30 1987		Brief amicus curiae of Arthur Andersen & Co., et al. filed.
17	Apr 30 1987		Joint appendix filed.
18	Apr 30 1987		Brief of petitioners Basic Inc., et al. filed.
19	Apr 30 1987		Brief amicus curiae of United States filed.
20	Apr 30 1987	G	Motion of American Corporate Counsel Association for leave to file a brief as amicus curiae filed.
21	Apr 30 1987		Brief amicus curiae of American Institute of Certified Public Accountants filed.
22	May 18 1987		Motion of American Corporate Counsel Association for leave to file a brief as amicus curiae GRANTED. The Chief Justice OUT.
23	May 18 1987	D	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
24	Jun 1 1987		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument DENIED. The Chief Justice OUT.
25	Jun 1 1987		Order extending time to file brief of respondent on the

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Entry	Date	Note	Proceedings and Orders
27	Jun 2 1987		merits until June 17, 1987.
28	Jun 2 1987		Application of respondents for leave to file a brief on the merits in excess of the page limits filed, and order granting same by Scalia, J., on 6/3/87. The brief may not exceed 55 pages.
29	Jun 18 1987		Brief of respondents Max L. Levinson, et al. filed.
30	Jul 2 1987		CIRCULATED.
31	Aug 31 1987		SET FOR ARGUMENT. Monday, November 2, 1987. (4th case).
32	Sep 15 1987	D	Motion of Joseph Harris, et al. for leave to file a brief as amici curiae, out-of-time, filed.
33	Oct 5 1987		Motion of Joseph Harris, et al. for leave to file a brief as amici curiae, out-of-time, DENIED. The Chief Justice and Justice Scalia DUT.
34	Oct 21 1987	X	Reply brief of petitioner Basic Inc., et al. filed.
35	Nov 2 1987		ARGUED.

**PETITION
FOR WRIT OF
CERTIORARI**

86-279
No. —

Supreme Court, U.S.

FILED

AUG 23 1986

SPANIOL, JR.
CLERK

IN THE
Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust, and
RONALD M. NEWMAN,

Respondents.

**PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT**

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QUESTIONS PRESENTED

1. Did the Court of Appeals err, in an action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, in holding that statements by a company denying the existence of merger negotiations or other corporate developments which might account for unusual trading activity in its shares were materially false and misleading where the contacts between the company and a third party expressing a possible interest in merging with the company were preliminary in nature and had not reached the stage of an agreement in principle?
2. Did the Court of Appeals err, in an action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, in approving certification of a class of all persons who, during a fourteen-month period, sold shares of a company which had issued three allegedly false and misleading statements, by applying a presumption of reliance as a substitute for the requirement that each class member show that his decision to sell his shares was made in reliance on one of the statements?

**PARTIES TO THE PROCEEDING
AND RULE 28.1 LIST**

The caption of the case in this Court contains the names of the parties to the proceeding except Mathew J. Ludwig, a former director of petitioner Basic Incorporated, who died on July 17, 1986, and is not a petitioner.

Petitioner Basic Incorporated is a wholly-owned subsidiary of Combustion Engineering, Inc. Combustion Engineering and its wholly-owned subsidiaries own a 20% or greater stock interest in the following domestic corporations:

Basic Ballistics Co.
Cast Industrial Products Co.
Combustion Engineering/
Neyrpic Hydro Power, Inc.
C-E/MHI Fan Co.
C-E/Studsvik, Inc.
L.S. Transit Systems, Inc.
Project Funding Corp.
Sea Plex Corp.
Spire Corp.
The Pryor Giggey Co.
Tyliner Inc.

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IN THE
Supreme Court of the United States
 OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
 JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
 H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
 WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
 trustee under the Karl Zuckerman Revocable Trust, and
 RONALD M. NEWMAN,

Respondents.

**PETITION FOR A WRIT OF CERTIORARI
 TO THE UNITED STATES COURT OF APPEALS
 FOR THE SIXTH CIRCUIT**

Petitioners Basic Incorporated ("Basic") and individuals who had been members of its board of directors prior to 1979 respectfully pray that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Sixth Circuit which (1) reversed an order of the United States District Court for the Northern District of Ohio granting summary judgment to petitioners and dismissing this action and (2) affirmed an earlier order certifying this case as a class action.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit (App. 1a-20a)¹ is reported at 786 F.2d 741 (1986). The opinion of the Court of Appeals, as amended, denying a petition for rehearing and suggestion for rehearing *en banc* (App. 144a-146a) is not reported.

The opinion of the United States District Court for the Northern District of Ohio granting summary judgment to petitioners (App. 21a-112a) is unofficially reported in part at [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,801 (1984). The District Court's opinions conditionally certifying the class and denying reconsideration thereof (App. 113a-140a) and the order of the Sixth Circuit denying interlocutory review (App. 141a) are not reported.

JURISDICTION

The judgment of the Court of Appeals was entered on March 27, 1986 (App. 142a-143a). Rehearing was denied by an order dated June 19, 1986, as amended by an order dated July 2, 1986 (App. 144a-146a). By an order of this Court dated June 10, 1986, the time to file this petition was extended to August 24, 1986 (App. 147a). This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTE AND RULES INVOLVED

The statute and rules involved in the proceeding are Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j; Rule 10b-5, 17 C.F.R. § 240.13e-101; and Rule 23, Fed. R. Civ. P. (App. 148a-150a).

¹ References to "App." are to the Appendix submitted with this Petition.

STATEMENT OF THE CASE

This class action, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, was commenced in June 1979 against Basic and former members of its board of directors. Respondents alleged that three public statements, issued by Basic during a fourteen-month period preceding the December 1978 announcement of an agreement for the acquisition of its shares by Combustion Engineering Inc. ("C-E"), were false and misleading in that such statements failed to disclose that, throughout that period, Basic and C-E allegedly were engaged in preliminary merger negotiations. Respondents further alleged that the impact of those statements was to cause the price at which Basic shares traded on the New York Stock Exchange (the "NYSE") to be artificially depressed and that they were damaged when, in purported reliance upon those statements, they and other members of the putative class sold their Basic shares during the fourteen-month period.

In August 1984, the District Court granted petitioners' motion for summary judgment dismissing this action in its entirety. In March 1986, the Sixth Circuit reversed the District Court's grant of summary judgment and affirmed an earlier District Court order certifying this case as a class action.

A. The Facts

As set forth in the opinions of the Courts below, the pertinent facts are as follows:

In the fall of 1976, James B. Kelly, a C-E executive, met with Max Muller, Basic's president, to discuss the possibility of an acquisition of Basic by C-E. Muller advised Kelly that Basic was not interested and preferred to remain independent. Muller thereafter provided Kelly with certain requested Basic sales data and met with Kelly several times between September and

December 1976 because Muller believed that Basic, though not for sale, was obligated to listen when another company expressed an interest in acquiring it. (App. 3a-4a, 45a).

In January 1977, Kelly advised Muller and Mathew J. Ludwig, Basic's financial vice-president, that C-E was interested in Basic but would not make an unfriendly tender offer. In October 1977, Kelly met with Muller, Ludwig and Anthony M. Caito, Basic's executive vice-president, and spoke generally about C-E and Basic. However, the Basic executives reiterated that Basic was not for sale, and no further meetings were scheduled. (App. 4a-5a, 46a-47a, 53a-55a).

On October 21, 1977, a Cleveland newspaper published the following article which contained the first statement of which respondents complain. The article was based on a press release issued by Basic to dispel merger rumors involving Basic and Flintkote (App. 5a, 59a):

**BASIC INC. STOCK REACHES
NEW HIGH IN HEAVY TRADING**

Stock of Basic Inc. reached a new high of 20 5/8 yesterday on volume of 29,000 shares, closing at 20. It was as low as 15 but has been heavily traded lately, including 40,000 shares Oct. 7.

President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland-based maker of refractories for the steel industry.

In November 1977, Kelly asked Muller whether Basic was ready to merge and Muller replied "not yet". (App. 67a). During early 1978, Basic developed an interest in acquiring C-E's refractories division which it discussed with Kelly, and in June 1978, Basic presented Kelly with a formal proposal for the acquisition of that division. Kelly rejected the proposed

price as too low and instead suggested that C-E acquire Basic for \$28 per share. Basic rejected Kelly's suggestion and, when Kelly suggested that he would ask C-E to give its "best figure", Basic discouraged him from doing so. Later in June 1978, when Muller telephoned to request additional information concerning C-E's refractories division, Kelly suggested that counsel for Basic and C-E should meet to discuss the antitrust implications of any C-E and Basic combination. No such meeting was held. (App. 5a-7a, 68a-71a, 77a-78a).

In July 1978, in telephone conversations between Kelly and Muller, Kelly (i) said that he would prepare an informal offer for Basic; (ii) requested Basic's earnings projections for use at a planned meeting with C-E's financial adviser, First Boston Corporation; (iii) inquired about unusual trading activity in Basic shares and was informed that Muller did not know the reason; and (iv) advised Muller that C-E and its counsel might consider contacting antitrust officials concerning a possible acquisition of Basic. Subsequently, Muller provided Kelly with the projections and information relevant to a possible antitrust analysis, but no "informal offer" and no antitrust analysis were prepared, and no approach to antitrust officials was made. These were the last contacts between Kelly and Muller until late November 1978. (App. 6a-8a, 80a-88a).

On September 25, 1978, during a period of unusual trading activity in its shares, Basic, at the request of the NYSE, issued the second statement of which respondents complain, as follows:

Basic Incorporated (NYSE-BAI) today reported that, although confident of the company's current and future business prospects, management is unaware of any present or pending company development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days. (App. 7a, 89a).

Basic repeated the substance of that statement in its nine-month report dated November 6, 1978, in the third statement of which respondents complain, as follows:

With regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months. (App. 7a).

In late November 1978, Kelly met with Basic for the first time since June 1978 and stated that C-E might consider an acquisition of Basic at \$35 per share. Muller stated that any such offer would be too low. Kelly had no subsequent contact with Basic until December 14 when, upon being authorized for the first time by the C-E Executive Committee to make an offer for Basic, Kelly telephoned Muller to request a meeting to discuss a possible acquisition. On December 18, after trading in Basic was halted, at its request, prior to the opening of the NYSE, Kelly met with representatives of Basic and, simultaneously, the investment bankers for Basic and C-E met for the first time to discuss the price and structure of a possible merger. On December 20, prior to the resumption of trading, it was announced that an agreement had been reached whereby C-E would make a tender offer for Basic shares at \$46 per share. (App. 8a, 33a-44a).

B. The District Court's Decisions

1. The Grant of Class Certification

Respondents sought certification of a class of all sellers of Basic shares during the fourteen-month period ending December 15, 1978. They contended that the market price of Basic shares throughout that period had been artificially depressed by the three statements complained of, and that all members of the putative class, as sellers on the NYSE—an open or impersonal market—were entitled to a presumption of reliance on the integrity of that market, even those who could not show

that they had relied on any of the statements in reaching their decisions to sell. In December 1981, the District Court granted class certification, explicitly noting that denial of class certification would have been required without a presumption of reliance because, if each class member had to show actual reliance, individual issues would have predominated over issues common to the class within the meaning of Rule 23(b)(3), Fed. R. Civ. P. (App. 113a-127a).²

2. The Grant Of Summary Judgment

After discovery, petitioners moved for summary judgment on the grounds that, as a matter of law, none of the three statements about which respondents complain was (i) false or misleading, (ii) material, or (iii) wilfully or recklessly made. In August 1984, the District Court granted summary judgment dismissing the action. (App. 21a-112a).

The District Court analyzed the contacts between Basic and C-E to determine whether, when each of the three statements was issued, those contacts had progressed to the point where they constituted "negotiations which might imminently produce an agreement in principle." (App. 100a). It held that the October 1977 statement was neither false nor misleading because Basic and C-E had not engaged in any merger negotiations. (App. 65a). With respect to the September and November 1978 statements, the District Court held that, even though Basic and C-E had previously engaged in "preliminary merger discussions," those discussions could not "be legally characterized as negotiations which might imminently produce an agreement in principle", and therefore that those statements were not materially misleading by reason of their failure to disclose the discussions. (App. 100a-101a, 104a).

² Although, following reconsideration, the District Court amended its order to permit interlocutory review, the Court of Appeals denied permission to appeal. (App. 128a-141a).

C. The Court Of Appeals Decision

1. The Reversal of Summary Judgment

The Sixth Circuit disagreed with the District Court's view of materiality and reversed the grant of summary judgment to petitioners. It held that the failure to disclose information relating to the contacts between Basic and C-E rendered the statements inaccurate in various respects. It also held that this undisclosed information was made material by the issuance of the statements, without any attempt to ascertain whether, when each statement was issued, the contacts between Basic and C-E had progressed to a point where there was a reasonable likelihood of a possible merger.

The Court below recognized that its decision is in conflict with the Third Circuit's decision in *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, ___ U.S. ___, 105 S. Ct. 1189 (1985), which held that until an agreement in principle had been reached on terms fundamental to a merger (e.g., price and structure), preliminary merger contacts are not material and that, therefore, a statement denying knowledge of any corporate developments to account for unusual trading activity is not false or misleading.³ The Court stated that *Greenfield* "expressed a view with which we are in disagreement, holding in a similar fact situation that such a statement was not false or misleading." (App. 13a).

2. The Affirmance Of Class Certification

The Sixth Circuit affirmed the District Court's class certification order. (App. 16a-20a). After noting that the District Court had "found the [predominance] requirement of Rule

³ As used hereafter, the term "no corporate developments statements" will describe statements, such as those here and in *Greenfield*, issued by a public company in response to inquiries, usually by a national securities exchange, concerning unusual trading activity in its shares. See, New York Stock Exchange Listed Company Manual § 202.03, "Dealing With Rumors or Unusual Market Activity".

23(b)(3) problematic," the Court below approved the application of a presumption of reliance "[t]o circumvent what the district court perceived to be a barrier to class actions in 10b-5 cases." (App. 16a).

REASONS FOR GRANTING THE WRIT

I. THERE IS A DIRECT CONFLICT BETWEEN THE THIRD AND SIXTH CIRCUITS ON THE STANDARD OF MATERIALITY WHICH PRESENTS AN IMPORTANT ISSUE UNDER THE FEDERAL SECURITIES LAWS THAT WAS INCORRECTLY DECIDED BELOW

The Sixth Circuit acknowledged that its decision was in direct conflict with the Third Circuit's decision in *Greenfield*. (App. 13a). Each case involved a public company which had (i) experienced unusual trading in its shares; (ii) had preliminary merger contacts with a company by which it would subsequently be acquired; and (iii) in response to exchange inquiries, issued a no corporate developments statement at a time when no agreement in principle on the price and terms of a merger had been reached.

Greenfield held that preliminary merger contacts are not material if no agreement in principle has been reached on terms fundamental to a merger, such as price and structure. Thus, under *Greenfield*, a no corporate developments statement does not, as a matter of law, become actionable under Rule 10b-5 merely because such contacts are not disclosed. The Third Circuit's test properly views a statement in the context in which it is issued and bases the determination of materiality thereon. In contrast, the Sixth Circuit held that, because of the issuance of the statements, the materiality of any contacts would be conclusively established.

This conflict between the materiality standards of the Third and Sixth Circuits presents an issue of major importance in the orderly administration of the federal securities laws. The uncertainty resulting from the decision of the Court below has

generated critical commentary among securities professionals. See, e.g., Brodsky, "Disclosure of Merger Negotiations," New York Law Journal, July 2, 1986, p. 1; Bloomenthal, "Materiality—Litmus Test or Chameleon," Parts I and II, 8 Sec. & Fed. Corp. L. Rep., p. 121 (May 1986) and p. 129 (June 1986); Goldstein, *et al.*, "Disclosure of a Potential Change in Corporate Control," 19 Review of Securities and Commodities Regulation, p. 133 (June 11, 1986); "Denial Versus Disclosure: A Continuing Controversy," P-H Information Services Corporate Acquisition Ideas (May 1986), p. 1.

The Securities and Exchange Commission (the "SEC") set forth its view of a company's obligation to disclose preliminary merger contacts when it issues a no corporate developments statement in *In re Carnation Co.*, Sec. Exch. Act. Rel. No. 22214, 33 SEC Docket, p. 874, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985). There, Carnation had issued statements in response to specific rumors linking it with Nestle. In one such statement, Carnation denied that it was negotiating with Nestle, even though at the time the statement was issued active negotiations were underway. The SEC analyzed the status of those negotiations at the time the statement was issued and determined that they were far advanced and therefore material. Although the SEC was critical of the *Greenfield* analysis (p. 877 n. 8), it did not suggest that materiality could be presumed by virtue of any inaccuracy in the statement itself.⁴

⁴ The SEC also stated in *Carnation* that

"an issuer that wants to prevent premature disclosure of non-public preliminary merger negotiations can, in appropriate circumstances, give a 'no comment' response to press inquiries concerning rumors of unusual market activity." SEC Docket at 877 n.6.

Two SEC Commissioners have subsequently expressed misgivings about such a response. See 18 Sec. Reg. & L. Rep. (BNA) 521 (April 11, 1986) and Fed. Sec. L. Rep. (CCH) Part One, pp. 5-6 (No. 1173, April 16, 1986) (report of speech by SEC Commissioner Grundfest) and 18 Fed. Sec. Reg. & L. Rep. (BNA) 441 (March 28, 1986) (report of speech by SEC Commissioner Fleischman).

The area of disclosure of preliminary merger negotiations has thus become a source of widespread debate and uncertainty.⁵ The conflicting decisions of the Third and Sixth Circuits have heightened the uncertainty and intensified the debate. The issue, which arises almost daily in connection with tender offers, mergers and other forms of business combinations, presents a serious problem for responsible corporate management.

The financial and commercial communities have an urgent need for a clear rule to guide those responding to inquiries concerning unusual trading activity when there have been some contacts which may—or may not—ultimately lead to a merger. If a no corporate developments statement discloses information not ripe under *Greenfield* but required by the Court below, a company risks litigation by those who purchased in anticipation of an acquisition.⁶ If, however, the company issues a statement but withholds disclosure of preliminary merger contacts, it risks litigation by those who assert that, under the standard of the Court below, the discussions had become material by virtue of the statement. Unless resolved, this conflict will cloud the question of when disclosure of preliminary merger contacts must be made and will place responsible corporate management in an untenable position. Review by this Court to resolve this conflict is imperative.

As hereafter shown, the standard established by the Court below cannot withstand careful scrutiny. The *Greenfield* agree-

⁵ See, e.g., Behr, "Gray Ethics," Wash. Post, Feb. 27, 1986, § E, p. 1; Vise, "SEC Forum Fails to Find Solutions for Rumors," Wash. Post, Feb. 20, 1986, § E, p. 1; Olson, "Revealing Merger Talks," Legal Times, Oct. 14, 1985, p. 11; Lunzer, "No Comment," Forbes, Sept. 16, 1985, p. 41; Poser, "Surprise! The SEC Says You Shouldn't Tell Lies About Merger Negotiations," Investment Dealers' Digest, Aug. 26, 1985, p. 36. See also articles cited *supra* at p. 10.

⁶ As stated in *Reiss v. Pan American World Airways Inc.*, 711 F.2d 11, 14 (2d Cir. 1983), there is "no doubt that had [the corporation] disclosed the existence of negotiations . . . and had those negotiations failed, we would have been asked to decide a Section 10b-5 action challenging that disclosure."

ment in principle standard correctly conforms to the standard of materiality established by this Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

A. The Court Below Erroneously Held That, Upon The Issuance Of A No Corporate Developments Statement, The Materiality Of Any Preliminary Merger Contacts Will Be Conclusively Presumed

The decision of the Court below requires companies issuing public statements concerning knowledge of corporate developments which might account for unusual trading activity to disclose any and all contacts relating to a possible merger—no matter how tentative or inconclusive—in order to avoid liability under Rule 10b-5. According to the Court below, any communication from or with a third party which may be interested in an acquisition becomes material and must be disclosed whenever a no corporate developments statement is issued: “even discussions that might not have been material in the absence of the denial are material because they make the statement made untrue.” (App. 14a-15a).

The Court below held that once a no corporate developments statement is issued, the materiality of any undisclosed preliminary merger contacts will be conclusively established without regard to whether (i) the contacts were insignificant or stale; (ii) the company had any reason to believe that the unusual trading activity was connected to the contacts; or (iii) there is any claim that an insider sought to benefit from the undisclosed information by trading or tipping.⁷ It stated:

⁷ Where a defendant seeks to take advantage of superior knowledge of preliminary merger contacts to withhold information from a plaintiff whose stock he subsequently purchases, and a merger thereafter takes place, courts have usually found the withheld information to be material. See, e.g., *Michaels v. Michaels*, 767 F.2d 1185 (7th Cir. 1985), *cert. denied*, ___ U.S. ___, 106 S. Ct. 797 (1986) (defendants purchased stock from plaintiff, their nephew); *Holmes v. Bateson*, 583 F.2d 542 (1st Cir. 1978) (defendants purchased stock from plaintiff, the widow of their deceased partner, without disclosing the existence of preliminary merger discussions); *Nelson v.*

“When a company whose stock is publicly traded makes a statement, as Basic did, that ‘no negotiations’ are under-way, and that the corporation knows of ‘no reason for the stock’s activity,’ and that ‘management is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity,’ information concerning ongoing acquisition discussions becomes material *by virtue of the statement denying their existence.*”

* * *

... In analyzing whether information regarding merger discussions is material such that it must be affirmatively disclosed to avoid a violation of Rule 10b-5, the discussions and their progress are the primary considerations. However, once a statement is made denying the existence of any discussions, even discussions that might not have been material in the absence of the denial are material because they make the statement made untrue.” (App. 12a-13a, 14a-15a) (emphasis in original).

Serwold, 576 F.2d 1332 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978) (defendants purchased plaintiff’s stock without disclosing, in response to plaintiff’s specific question, the existence of a firm plan to sell the company); and *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975) (defendant, plaintiff’s partner, purchased plaintiff’s stock without disclosing its firm plan to sell the company). See also *Securities and Exchange Commission v. Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976) (corporate insider tipped information concerning a firm plan to merge to third parties who traded thereon) and *Securities and Exchange Commission v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974) (trading by brokers negotiating a merger). As stated in *Rothberg v. Rosenbloom*, 771 F.2d 818, 821 (3d Cir. 1985), “[t]he best proof of the materiality of [nondisclosed] information is that the [defendants], themselves experienced investors, found it to be sufficiently material . . . to purchase . . . stock when it was depressed in price.”

The issue of materiality, as presented here, does not involve claims against persons who traded. Instead, it relates to claims by persons trading on the impersonal or open market against defendants who are not alleged to have traded, tipped or otherwise acted to serve their own self-interests. (App. 27a, 32a n.11). Thus, materiality principles derived from cases where defendants seek to benefit from the undisclosed information are not relevant here.

The Court below thus improperly merged the statutory requirement of materiality into the separate statutory requirement that the statement be false or misleading. This ruling effectively eliminates materiality as a distinct element of a claim for relief under Rule 10b-5. It creates a standard unworkable in practice, unjustified by policy or precedent and—as here—likely to result in an unjust decision.

A proper approach to determining the materiality of preliminary merger contacts must include an analysis of whether, at the time of the issuance of a statement, the contacts had progressed to the point that there was a reasonable likelihood that a consummated merger would occur.⁸ The Court below failed to take that approach. Instead, it deemed the alleged inaccuracy⁹ of the statements conclusive on the issue of materiality: “even discussions that might not have been material in the absence of the denial are material because they make the statement made untrue.” See p. 13, *supra*.

Compounding its error, the Court below gave the statements a broad reading which is unwarranted.¹⁰ “A statement that ‘no

⁸ As stated in *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), materiality “will depend at any given time upon a balancing of the indicated probability that the event will occur and the magnitude of the event in light of the totality of the company activity.” The District Court below, consistent with the view of *Texas Gulf*, held that contacts, to be material, should reflect “negotiations destined, with reasonable certainty, to become a merger agreement in principle.” (App. 103a).

⁹ The Court below did not evaluate the accuracy of the statements in light of the information known to Basic. For example, as to the October 1977 statement, it ruled that “[b]ecause of the ‘Strategic Plan’ of Combustion regarding Basic, had there been only one telephone call from Kelly to Muller, this statement would have been clearly untrue. Thus the various denials by Basic were affirmative misrepresentations.” (App. 11a).—But it did not explain how this purely internal plan formulated for submission to C-E’s corporate management—which, in fact, did not approve it (App. 53a)—could have had any bearing on the accuracy of the October 1977 statement when its existence never was known to Basic.

¹⁰ Although the Court below repeatedly referred to denials of merger negotiations, only the October 1977 statement, issued to deny rumors

negotiations’ were occurring could reasonably be read to state that *no* contacts of any kind whatsoever regarding merger had occurred.” (App. 11a) (emphasis in original). Thus, the Court did not even attempt to consider whether the Basic and C-E contacts were, in fact, material at any relevant time. Instead, it held that if a no corporate developments statement—given its broadest conceivable reading—was inaccurate in any way, the materiality of *any* contacts relating to a possible merger would conclusively be presumed, even if the alleged “negotiations” or “corporate developments” consisted of “only one telephone call.”

B. The Third Circuit In *Greenfield* Properly Ruled That Until An Agreement In Principle Is Reached, Preliminary Merger Contacts Are Not Material And Need Not Be Disclosed In A No Corporate Developments Statement

In *Greenfield*, the Third Circuit properly focused on the significance of the undisclosed contacts at the time a no corporate developments statement was issued. In affirming summary judgment for defendants, it held that such a statement could not be found materially inaccurate because, at the time of its issuance, the company and its prospective acquirer had not yet reached an agreement in principle on terms fundamental to a possible merger, such as price and structure. Thus, the company’s failure to disclose its discussions with its prospective acquirer did not render its statement materially misleading. 742 F.2d at 759.

In *Greenfield*, a company met with a friendly suitor after it had received a series of unacceptable demands from a third party pursuing a hostile takeover attempt. Five days after that meeting, following unusual trading activity in its shares and an inquiry from the NYSE, the company issued a no corporate

unrelated to C-E, referred to merger negotiations. (See, e.g., App. 2a, 10a, 11a, 13a, 14a) Both the September and November 1978 statement deny a “present or pending company development” which would “explain” or “account for” unusual trading activity; they make no reference to merger negotiations.

developments statement. Twelve days later, its investment bankers and those of its friendly suitor met for the first time to discuss the price and structure of a merger. Two days later, a merger was announced.¹¹

In analyzing the company's duty to disclose, the Third Circuit stated (742 F.2d at 756-57):

"Merger discussions arise in a wide variety of circumstances and the standard used to determine when disclosure of these is required must be both flexible and specific. . . . [T]he possibility of substantial liability for tardy disclosure, would likely result in corporations issuing early public statements announcing the details of all merger talks. Not only would this have a disruptive effect on the stock markets, but, considering the delicate nature of most merger discussions, might seriously inhibit such acquisitive ventures.

Under the facts of the present case, it was more appropriate for the court below to determine that an agreement in principle to merge had been reached when the parties reached agreement on 'price and structure.' Although it is difficult to draw a bright line definition that will apply to all cases, these two factors are typically critical aspects of any merger. Agreement as to price and structure provides concrete evidence of a mature understanding between the negotiating corporations. They constitute a useable and definite measure for determining when disclosures need be made."

In *Greenfield*, the Third Circuit was mindful of the inherent dangers of premature disclosure both to the disclosing company and the investing public. Its agreement in principle

¹¹ The two-week period between the issuance of the statement and the public announcement of the merger in *Greenfield* is in striking contrast to the lengthy periods—fourteen months, three months and one month, respectively—that separated the three statements issued by Basic from the announcement of its agreement with C-E.

standard is "both flexible and specific" (742 F.2d at 756) and sensitive to the need to balance a company's interest in avoiding premature and disruptive disclosure of merger contacts and the investment community's interest in all information concerning that company, whether material or not. Thus, the Third Circuit properly determined that "with both price and structure agreed to, there is only a minimal chance that a public announcement would quash the deal or that the investing public would be misled as to likely corporate activity." 742 F.2d at 757.

While *Greenfield* attempted to accommodate these competing interests by determining the point at which disclosure is appropriate, the Court below simply ignored the need to strike a balance. Instead, it adopted a rule that, unless modified, mandates disclosure of information which would otherwise be viewed as too inconsequential and uncertain to be material.

C. The Decision Of The Court Below Fails Properly To Apply The Rule Announced By This Court In *TSC*

This Court has not specifically ruled upon the standard of materiality applicable to the obligation of a company to disclose the existence of preliminary merger contacts. Lower courts consequently have long utilized the general definition of materiality set forth in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), which held that information is material only if there is

"a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

TSC involved the materiality under the proxy rules of information relevant to shareholder approval of a proposed

acquisition. In seeking to apply *TSC*, the lower courts have sought to balance various factors deemed relevant to the particular cases before them.

The Second and Third Circuits have held that *TSC* does not require disclosure of preliminary merger contacts prior to the time that an agreement in principle has been reached, even though a company is actively soliciting the acquisition of its own securities. In *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982), the Third Circuit held that a company's failure to disclose preliminary merger contacts did not render documents soliciting a tender of shares materially misleading. In affirming summary judgment for defendants in a class action alleging, among other things, violations of Rule 10b-5, the Third Circuit emphasized the wisdom of withholding disclosure of such contacts until an agreement in principle has been reached (672 F.2d at 1206-7):

"A substantial body of opinion suggests that disclosure of preliminary merger discussions would, by and large, do more harm than good to shareholders and the values embodied in the anti-fraud provisions of the Act. . . .

* * *

Those persons who would buy stock on the basis of the occurrence of preliminary merger discussions preceding a merger which never occurs, are left 'holding the bag' on a stock whose value was inflated purely by an inchoate hope. If the announcement is withheld until an agreement in principle on a merger is reached, the greatest good for the greatest number results. If the merger occurs, all of the company's shareholders usually benefit; if no merger agreement is reached, the stock performs as it would have in any event."

Noting that *TSC* had "adopted a standard of materiality high enough to avoid management's 'bury[ing] the shareholder in an avalanche of trivial information'" (672 F.2d at 1205, quoting 426 U.S. at 448), *Staffin* held that preliminary merger discussions do not become material—and, therefore, need not be disclosed in a tender offer—until an agreement in principle

or the functional equivalent thereof is reached. 672 F.2d at 1207.

Similarly, in *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11, 14 (2d Cir. 1983), a company announcing a call of its debentures did not disclose that, on the same day, it had resumed negotiations for a merger which, one week later, was publicly announced. In affirming summary judgment for defendants in a class action alleging, among other things, violations of Rule 10b-5, the Second Circuit held that the company had no duty to disclose its merger discussions because no agreement in principle had been reached.

Both *Staffin* and *Reiss* recognized that *TSC* requires disclosure only of information which "would have assumed actual significance in the deliberations of the reasonable shareholder." Since preliminary merger contacts are not "hard facts which definitely affect a company's financial prospects" but rather "complex bargaining . . . which may fail as well as succeed" (*Reiss, supra*, 711 F.2d at 14), such information may not, as a matter of law, be found to assume "actual significance" to a reasonable shareholder.

The Court below misapprehended *TSC* and ignored its distinction between information which *would* assume actual significance to a reasonable shareholder and information which *might* assume such significance. By ruling that "even discussions that might not have been material in the absence of the denial are material because they make the statement made untrue," the Court below created a standard which defies logic and is wholly at odds with *TSC*. It failed to consider whether there is any "substantial likelihood that, under all the circumstances, the omitted fact" would have assumed "actual significance in the deliberations of a reasonable shareholder." No "reasonable shareholder" would view "only one telephone call" as "having significantly altered the 'total mix' of information made available." Rather, the analysis of the Court below is based on its mistaken assumption that an "average investor" *might* find information, even as to contacts so

remote and insubstantial as to render the possibility of a merger speculative at best, "important and, therefore, material." (App. 13a).

This Court explicitly declined to adopt such a test in *TSC*, where it rejected a standard under which any information which a reasonable shareholder "might consider important" would be deemed material. 426 U.S. at 446 (emphasis in original). Quoting *Gerstle v. Gamble-Skogmo*, 478 F.2d 1281, 1302 (2d Cir. 1973), this Court "agree[d] with Judge Friendly, speaking for the Court of Appeals in *Gerstle*, that the 'might' formulation is 'too suggestive of mere possibility, however unlikely.'" 426 U.S. at 449.

By creating a standard under which any information relating to preliminary merger contacts is deemed material—without regard to whether it was of such a nature that it reasonably "would have assumed actual significance"—the Court below plainly misapplied the materiality standard announced in *TSC*. Further, it erred by refusing to consider whether, at the time any statement here was issued, the preliminary merger contacts either had just begun or appeared to have terminated.¹² This refusal cannot be reconciled with the requirement that materiality must be determined " 'in the light of the facts existing at the time of the [statement]'. . . . [H]indsight is of limited value and the fact that ultimate disclosure of the negotiations affected stock price is not compelling." *Reiss, supra*, 711 F.2d at 13, quoting *Texas Gulf, supra*, 401 F.2d at 863.

Greenfield, in applying the standard of materiality developed in *Staffin* and *Reiss*, is consistent with *TSC*. It defines the

¹² Thus, at the time the September and November 1978 statements were issued, Muller and Kelly had not met for many months. (App. 6a-7a). The October 1977 statement was issued in response to a rumor involving a company other than C-E, and it is only by distorting that statement and taking one sentence out of context that it can even be read to deny merger negotiations generally. (App. 5a). In any event, the few contacts which had preceded that statement simply could not "have assumed actual significance" to anyone.

point at which preliminary merger contacts have progressed sufficiently so that there is a "substantial likelihood that, under all the circumstances," the contacts "would have assumed actual significance" to a reasonable shareholder. *TSC, supra*, 426 U.S. at 449. *Greenfield* recognizes that "facts that were subject to change at any time" may not be held to have "assumed actual significance" to a reasonable investor seeking to make an investment decision. 742 F.2d at 757. Thus, *Greenfield* requires disclosure of preliminary merger contacts only when they have progressed to the point that a merger is reasonably probable.¹³ Only at that point would information concerning such contacts "significantly alter the 'total mix' of information made available." *TSC* requires no more.

The *Greenfield* standard is properly sensitive to the real dangers presented by premature disclosure of preliminary merger contacts. The vast majority of expressions of interest concerning a possible acquisition never materialize into an actual acquisition. To require disclosure of any expressions of interest without regard to the likelihood that they would result in a consummated merger is to increase the risk that shareholders could be misled—and invite the lawsuits that will result therefrom. As this Court noted in *TSC*, 426 U.S. at 448-49:

"Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. The potential liability . . . can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision-making."

¹³ *Greenfield*, and cases consistent with it, recognize that merger "negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned." *Reiss, supra*, 711 F.2d at 14.

Just such an "avalanche of trivial information" would result from a requirement that disclosure of all preliminary merger contacts—no matter how tentative, inconclusive or stale—must be made whenever a no corporate developments statement is issued. Such a rule is contrary to *TSC* and not justified either by precedent or policy.

II. IN APPLYING A PRESUMPTION OF RELIANCE TO FACILITATE CLASS CERTIFICATION OF ACTIONS UNDER RULE 10b-5, THE COURT BELOW IMPROPERLY EXTENDED THIS COURT'S HOLDING IN *AFFILIATED UTE* AND DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT

This Court has expressed its concern with the potential abuse of class actions in *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 476 (1978) ("[c]ertification of a large class may so increase the defendant's potential damages liability and litigation costs that he may find it economically prudent to settle and to abandon a meritorious defense") and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 747-48 (1975) ("the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good").¹⁴

¹⁴ See also *Eisen v. Carlisle & Jacquelin*, 479 F.2d 1005, 1018, 1019 (2d Cir. 1973), vacated and remanded on other grounds, 417 U.S. 156 (1974) (recognizing that class actions "have sprouted and multiplied like the leaves of the green bay tree," and can have severe "'in terrorem' effects" which amount to "legalized blackmail" in cases "where the merits of the class representatives claim is to say the least doubtful") and *Parkinson v. April Industries, Inc.*, 520 F.2d 650, 654 (2d Cir. 1975) ("[T]he impact of large plaintiff class actions upon defendants is great. The expense of defense increases with the introduction of the enlarged class, with the broadening of the substantive issues, and with the preliminary pretrial skirmishing. Of perhaps greater importance in realistic terms is the increase in potential liability which could force the defendant to settle plaintiffs' claims regardless of the merits of the plaintiffs' cases.").

One significant method by which use of class actions has been expanded by the lower courts in Rule 10b-5 actions is through the use of a presumption of reliance as a substitute for the otherwise mandatory requirement that putative class members show that their reliance on alleged misrepresentations or omissions influenced their decisions to trade. The application of a presumption of reliance, which finds no support in any decision of this Court or in the language of Rule 10b-5, improperly circumvents the predominance requirement of Rule 23(b)(3), Fed. R. Civ. P.¹⁵ This Court has not considered the propriety of that presumption, and it is an issue of growing importance which ought to be resolved.

A. *Affiliated Ute* And The Availability Of A Presumption Of Reliance To Facilitate Class Certification

Courts which permit a presumption of reliance to facilitate class certification purport to base their rulings on this Court's decision in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). In fact, *Affiliated Ute*, which did not even involve class certification, provides no support for a generalized presumption of reliance. There, fiduciaries responsible for protecting the rights of shareholder beneficiaries purchased stock directly from their beneficiaries without disclosing that it was worth substantially more than the purchase price. This Court rejected the fiduciaries' contention that, to prevail, the shareholders would have to show actual reliance upon the failure to disclose the information as to the stock's value. It held that (406 U.S. at 153):

"Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material."

¹⁵ For class certification to be appropriate under Rule 23(b)(3), a court must find, among other things, that "the questions of law or fact common to the members of the class predominate over any questions affecting only individual members".

The *Affiliated Ute* decision is premised on the fact that proof of reliance on a failure to disclose is difficult, if not impossible. That rationale is inapplicable where, as here, the claims asserted arise from publicly disseminated written statements. See, e.g., *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 93 (2d Cir. 1981), quoting *Titan Group, Inc. v. Faggan*, 513 F.2d 234, 238-39 (2d Cir.), cert. denied, 423 U.S. 840 (1975):

"[*Affiliated Ute*], rather than abolishing reliance as a prerequisite to recovery, was recognizing the frequent difficulty in *proving*, as a practical matter, that the alleged misrepresentation, allegedly relied upon, caused the injury. . . Unlike instances of affirmative misrepresentation where it can be demonstrated that the injured party relied upon affirmative statements, in instances of total non-disclosure, as in *Affiliated Ute*, it is of course impossible to demonstrate reliance'. . . . What is important is to understand the rationale for a presumption of causation in fact in cases like *Affiliated Ute*, in which no positive statements exist: reliance as a practical matter is impossible to prove. . . . The situation here does not present that problem." (emphasis in original)

Nevertheless, from the narrow holding of *Affiliated Ute*—that reliance need not be proved in an action arising from nondisclosure by a fiduciary—certain courts have broadly presumed reliance to facilitate class certification in Rule 10b-5 actions, even those asserting claims arising from statements alleged to be false or misleading. In so doing, these courts have improperly eliminated reliance both as an essential element of a claim under Rule 10b-5 and as a means of appropriately limiting class certification.

In *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976), the Ninth Circuit utilized a presumption of reliance to facilitate certification of a class of purchasers. Plaintiffs claimed that defendants had misrepresented the financial condition of their company by not disclos-

ing a \$90 million loss in numerous public statements issued throughout a two-year period and that, as a result, the price of the stock purchased by them and members of the putative class had been artificially inflated.

Viewing *Affiliated Ute* as "a rejection of the burden [of proving reliance] because it leads to underinclusive recoveries and thereby threatens the enforcement of the securities laws," (524 F.2d at 908), *Blackie* held that a claimant could establish that he was caused to engage in the transaction at issue "by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance." 524 F.2d at 906. Accordingly, *Blackie* facilitated class certification by applying a rebuttable presumption which, in its view, would eliminate reliance as an individual issue otherwise predominating over other common issues and requiring denial of certification under Rule 23(b)(3).¹⁶

The *Blackie* rationale has been applied to permit a presumption of reliance facilitating class certification "even when a defendant [is] able to prove . . . that a plaintiff was indifferent" to the statements upon which his claim is based. See, e.g., *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), cert. denied, 465 U.S. 1026 (1984) (class certification granted in action alleging wrongful issuance of bonds, even though not all members of the putative class had received the allegedly misleading documents and, therefore, could not have relied upon them).

¹⁶ Although the Court in *Blackie* described its presumption as rebuttable, it recognized that attempts to rebut would rarely be successful (524 F.2d at 906-7 n. 22):

The 10b-5 private suit serves a public purpose, but has done so since its judicial creation in the framework of a private damage suit. We doubt the right to disprove causation will substantially reduce a defendant's liability in the open market fraud context, as we doubt that a defendant would be able to prove in many instances to a jury's satisfaction that a plaintiff was indifferent to a material fraud.

B. The Court Below Improperly Facilitated Class Certification By Extending The Presumption Of Reliance Beyond Any Reasonable Bounds

This case—involving sellers of securities in an open or impersonal market during a fourteen-month period—is wholly inappropriate for class certification. In affirming certification, the Court below utilized a presumption of reliance as a substitute for the otherwise mandatory showing that, in making decisions to trade, members of the putative class were aware of, and actually relied upon, one of the three statements in controversy. While the Court below purported to follow a line of cases in which a presumption of reliance was applied, it extended the presumption beyond its previous boundaries.

Ignoring the fact that the putative class here consists of sellers, the Court below (App. 19a) improperly looked to cases involving purchasers to support its holding. *See Blackie, supra*; *T.J. Raney, supra*; *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, ___ U.S. ___, 105 S. Ct. 814 (1985); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983); and *Ross v. A.H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 940 (1980).¹⁷

Even assuming that decisions to purchase securities traded in the impersonal market would be reached on a relatively common basis, influenced primarily by the market price of the stock, there is no reason to make the same assumption regarding decisions to sell, especially over a long period of time. Decisions to sell are likely to be highly individualized, reflecting primarily the particular financial condition and investment requirements of each seller, rather than the market price of the stock. For example, an individual's decision to sell may arise

¹⁷ *Lipton*, *Ross* and *Shores* did not address the availability of a presumption of reliance to facilitate class certification. *Lipton* and *Ross* involved the sufficiency of pleadings on a motion to dismiss, while *Shores* involved the existence of issues of fact on a motion for summary judgment.

from a desire to use the proceeds to purchase stock in a different company or from personal tax considerations. Indeed, individuals frequently sell simply to make funds available for other purposes.

The putative class here allegedly sold in reliance on statements denying merger negotiations or corporate developments. It is simply not reasonable to assume a common reaction to widely-separated statements discounting the possibility of an imminent merger or disclaiming knowledge that there were corporate developments to account for specific trading activity especially when those statements were issued over a fourteen-month period. It is extremely unlikely that a significant number of reasonable investors would premise their selling decisions on such information. Such a presumption assumes that those who became aware of a statement on the day it was issued would react to it in the same manner as those who became aware of it—or of one of the other statements—at widely different times over a fourteen-month period. This assumption is patently absurd on its face.¹⁸

C. The Presumption Of Reliance Increases The Potential For Abuse Of Class Actions

The approval of class certification here reflects a policy of promoting class actions involving the federal securities laws. Indeed, as the District Court below stated (App. 118a):

“To require proof of individualized reliance in every 10(b)(5) misrepresentation action would bar such actions from proceeding as class suits because the individual questions would far outnumber and overwhelm the com-

¹⁸ Significantly, *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535 (S.D.N.Y. 1982), the only case cited by the Court below (App. 18a) in which a class of sellers was certified, involved a class period of only eight days. The Court in *Schlanger* apparently believed that it could reasonably be assumed that sellers during such a short period could have been commonly influenced by a no corporate developments statement in reaching their decisions to sell.

mon ones. If every reliance issue must be treated as an individual issue, even bifurcation of these individual issues from the common questions would prove unmanageable and undermine the use of class action."

Utilization of a broad presumption of reliance improperly encourages class certification of actions asserting misrepresentation claims under Rule 10b-5 by essentially ignoring the fact that reliance is an individual element which predominates over common issues so as to require denial of class certification under Rule 23(b)(3).

No societal purpose is served by enabling persons who have never read—and therefore could not have relied upon—statements upon which a Rule 10b-5 claim is based to join as a class to pursue a potential windfall recovery. The approval of class certification here, facilitated only by the circumvention of the predominance requirement of Rule 23(b)(3) through the use of an unprecedented presumption, cannot be justified by reference to *Affiliated Ute*. A presumption of reliance provides no basis to support class certification of Rule 10b-5 claims by sellers on the open market based upon alleged misrepresentations.

The decision below carries the emasculation of the reliance requirement of Rule 10b-5 to the extreme and affords an appropriate occasion for this Court, which has never considered the question, to bring required clarification to an important area in which the federal rules and securities laws interplay.

CONCLUSION

For the foregoing reasons, petitioners respectfully request that this Court issue a writ of certiorari to review the decision of the United States Court of Appeals for the Sixth Circuit.

Dated: New York, New York
August 22, 1986

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APPENDIX

AUG 23 1986

JOSEPH F. SPANIOLO,
CLERKIN THE
Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust, and
RONALD M. NEWMAN,

Respondents.

**APPENDIX TO PETITION FOR A WRIT OF
CERTIORARI TO THE UNITED STATES COURT
OF APPEALS FOR THE SIXTH CIRCUIT**

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Nos. 84-3730, 84-3775, 84-3776

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MAX L. LEVINSON; KARL
ZUCKERMAN; RONALD M. NEWMAN,
Plaintiffs-Appellants (84-3730),
Plaintiffs-Appellees (84-3775/6),

v.

BASIC INCORPORATED,
Defendant-Appellee (84-3730),
Defendant-Appellant (84-3775),

ANTHONY M. CAITO; SAMUEL
EELLS, JR.; JOHN A. GELBACH;
HARLEY C. LEE; MATHEW J.
LUDWIG; MAX MULLER; H.
CHAPMAN ROSE; EDMUND G.
SYLVESTER and JOHN C. WILSON,
JR.,
Defendants-Appellees (84-3730),
Defendants-Appellants (84-3776).

ON APPEAL from the
United States District
Court for the North-
ern District of Ohio.

Decided and Filed March 27, 1986

Before: MARTIN, JONES and WELLFORD, Circuit
Judges.

BOYCE F. MARTIN, JR., Circuit Judge.

FACTUAL BACKGROUND

This securities case presents two large legal questions which must be decided in the context of a multitude of small facts. The facts tell the story of contacts and discussions between officials of Basic Incorporated and Combustion Engineering, Incorporated, which eventually led to the merger of these two publicly traded corporations. In this setting, we are called upon to analyze the propriety of a summary judgment given to the defendants upon a finding that section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 were not violated by representatives of Basic when they made certain public statements. We also must examine the class certification made by the district court.

The named plaintiffs are Max L. Levinson, Karl Zuckerman and Ronald M. Newman, representing all other shareholders who sold Basic Incorporated common stock between October 21, 1977, and December 15, 1978. They claim that they relied, to their detriment, on three statements issued by Basic during that time which denied that any merger discussions were occurring. They claim that these statements were false and misleading because merger discussions were in fact occurring; and thus, the defendants violated section 10(b) and Rule 10b-5. The plaintiffs claim that they sustained substantial losses because they relied on the statements and sold their shares of Basic at an artificially low price. They seek recovery of their losses from Basic as well as from Anthony M. Caito, Samuel Eels, Jr., John A. Gelbach, Harley C. Lee, Matthew J. Ludwig, Max Muller, H. Chapman Rose, Edmund G. Sylvester and John C. Wilson, Jr.—all officers or directors of Basic.

Two rulings of the district court have been appealed upon a voluminous and rather detailed record. First, the district court granted summary judgment for the defendants based upon a finding that the statements, as a matter of law, were

not material and therefore not false and misleading and that, as a matter of law, the defendants did not act with scienter. Second, the district court applied a presumption of reliance so that a class consisting of all parties who sold Basic stock during the merger negotiations could be certified as required by Rule 23 of the Federal Rules of Civil Procedure. With the presumption, reliance became a question common to all the class members rather than an individual question for each plaintiff. Therefore, the district court found that common questions of the class of stockholders predominated over individual questions as required by Rule 23. Having satisfied Rule 23, the class could be certified. The defendants claim that the class should not have been certified because use of this presumption was improper.

Until December 20, 1978, Basic primarily manufactured chemical refractories. Basic's stock was traded on the New York Stock Exchange. Combustion Engineering, the potential acquirer, engaged in a wide range of businesses, including the manufacture of alumina or acid-based refractories. Combustion's stock was also traded on the New York Stock Exchange. Combustion had been interested in acquiring Basic since 1965 or 1966. However, it was not until 1976, in the Kaiser-Lovino proceeding, that the Federal Trade Commission considered eliminating antitrust barriers to a merger of Basic and Combustion.¹ Included as a part of the "Strategic Plan" of Combustion's Industrial Products Group, dated October 25, 1976, was the statement "[a]cquire Basic, Inc. \$30 million."

Beginning in September of 1976, James Kelly, Vice-President in charge of Combustion Engineering's Industrial Products Group, and other Combustion employees held a number of meetings and telephone conversations with Basic

¹In the Kaiser-Lovino proceeding, the FTC took the position that basic or chemical refractories were in a separate market than acidic or alumina refractories.

and its officers. One such contact occurred in September of 1976, when James Kelly telephoned Max Muller, the Chairman and Chief Executive Officer of Basic. The admitted purpose of the call was to arrange a meeting with Basic's management to discuss a possible merger. Between September, 1976, and October, 1977, Kelly made numerous telephone contacts as well as trips from Combustion's Connecticut offices to Basic's Cleveland offices. During these visits and in telephone conversations, Kelly talked with Muller, Matthew J. Ludwig, senior vice-president of Basic, and Anthony M. Caito, executive vice-president of Basic. They discussed Combustion's interest in acquiring Basic, "how we [Combustion] operated companies like Basic after acquisition," and that Combustion would consider Basic an independent unit after acquisition. During this period Combustion's lawyers were conducting an antitrust investigation for the acquisition and Muller provided Kelly with confidential, non-public information relating to Basic's sales and operations. In November, 1976, at a special meeting of the Executive Committee of Combustion's Board, Kelly was authorized to "continue to proceed" with "investigations, preparations and, as appropriate, negotiations with respect to the possible acquisition of Basic." Kelly told Basic of this authorization. Combustion's management told Combustion's investment bankers, First Boston, of the company's desire to acquire Basic and requested that they prepare analyses for the acquisition of prices of eighteen, twenty and twenty-two dollars per share.

At Basic, Muller circulated two memoranda to Basic's Board of Directors, both entitled "Recent Interest in Basic," in which Muller informed the Board of the meetings with Combustion's management and Combustion's antitrust study of the acquisition of Basic. At this stage no public statements had been made by either the Board of Basic or the Board of Combustion. In April, 1977, according to a time report of H. Chapman Rose, a Basic director and attorney, Rose met with other Basic lawyers to discuss a "possible bid

by Combustion." An analysis was prepared which evaluated a merger with Combustion. Ludwig sent this analysis to Rose with a transmittal letter which stated, "Herewith the C-E 1976 Annual Report and the analysis we usually make in considering mergers or acquisitions which I promised." Other such analyses were prepared in March, 1978, and after September, 1978. In August, 1977, and on October 18, 1977, Basic's Management met with Basic's investment bankers, Kidder, Peabody, to discuss preparation of a valuation of Basic for use in the merger negotiations. Combustion again listed acquisition of Basic in its "Strategic Plan" of September 23, 1977. On October 12, 1977, Kelly met with Muller, Ludwig and Caito at Basic's offices. Kelly stated that they discussed the role Basic would have in Combustion's corporate structure. Throughout 1977 and 1978, there were repeated bouts of trading activity in Basic stock. On October 19 and 20, 1977, the trading volume of Basic soared from an average 6,000 to 8,000 shares per day to 29,000 shares per day. On October 21, 1977, the first public announcement from Basic by Muller, as reported in *The Cleveland Plain Dealer*, was issued and read in part:

President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland-based maker of refractories for the steel industry.

Muller contends that this statement was issued to deny a rumor that Basic might merge with another company, Flintkote, and that the statement had nothing to do with the rather detailed discussions with Combustion.

Between October, 1977, and September, 1978, contacts continued between Basic and Combustion. Confidential information including very favorable financial forecasts and projections, analyses of the effects of the merger, and infor-

mation about other companies interested in Basic was exchanged at numerous times. Kelly and Basic, especially through Muller, were often in contact. On June 7, 1978, Kelly met with Muller, Ludwig and Caito and gave them analyses prepared by Combustion. Muller's diary entry for the meeting stated, "Jim Kelly of CE offered \$28.00." Muller said that the offer was "too low." Kelly then stated that Combustion would give a better figure but Muller told Kelly to "hold off til we tell you." Muller later stated that he wanted the Kidder, Peabody valuation of Basic to assist him in evaluating the offer. Muller, Ludwig and Caito then met with Rose and discussed the Combustion merger. They decided to ask Combustion for its "best offer." Rose advised the management to "stay out of the market."

On July 10, Muller noted in his diary that he and Kelly agreed in a telephone conversation that "Kelly will prepare an informal offer." Kelly advised against public disclosure at this time. Later in July, Kelly and Muller agreed that a "slow, deliberate approach" was proper. During this time, Combustion's investment bankers, First Boston, prepared analyses of acquisition prices at Combustion's direction and the Combustion Executive Committee renewed its support of the merger.

On July 14, the price of Basic's stock rose sharply.² David Dolan, the Exchange officer in charge of Basic stock, called Theodore Thomas, who had been designated as Basic's exchange liaison. Again Basic, through Thomas, denied that any undisclosed merger or acquisition plans or any other significant corporate developments existed. On September 14, 1978, at Combustion's request, First Boston prepared and delivered to Kelly a draft proposal letter for the acquisition of Basic.

²By 2:52 p.m. the price of Basic stock was up 3-1/8 points (or more than 12%) to 26-7/8 on a trading volume of approximately 18,200 shares.

On September 25, the price of Basic stock again rose.³ Dolan, the Exchange official, called Ludwig at Basic and asked whether there were any undisclosed "merger or acquisition" plans, any developments relating to a possible "tender offer," any developments relating to prior announcements, any rumors, or any other significant corporate developments. For the third time, Basic flatly denied that there were any corporate developments. Ludwig consulted with Muller, who was in Europe, and issued the following untruthful release to the press which stated:

management is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days.

Yet, the contacts between the two companies continued. The Kaiser-Lovino ruling that basic and non-basic refractories were separate markets was issued on October 12, so Kelly was advised that it "would be a good time to get the acquisition done." In the first week of November, Basic issued a "Nine Month Interim Report to Shareholders," in which for the fourth time it stated:

With regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months.

On November 21, Muller telephoned John C. Wilson, Jr., an outside director of Basic, and discussed an offer from

³By 11:25 a.m., Basic stock was up 2-1/2 points to 32-7/8 on a volume of approximately 28,500 shares, even though the Dow Jones Index was down more than 3 points. The prior trading day, Basic had risen another 2-1/8 points on volume of some 31,900 shares. Normal trading volume in Basic stock was 2,000 to 8,000 shares.

Combustion in the forty-five to fifty dollar range. On November 27, Kelly met with Muller, Caito and Ludwig and suggested an all cash price of thirty-five dollars per share. The price was refused. The next few weeks were a time of great activity as meetings were held and studies completed. On December 14, Combustion's Executive Committee approved acquisition of Basic at forty-six dollars per share. On Friday, December 15, Basic's stock price soared and for the fifth time Basic, with Thomas as the spokesman, answered the Exchange inquiry with a denial of corporate developments. Between January 1978 and October or November 1978, Ted Mayer, an analyst with Legg, Mason, Wood, Walker, Incorporated, was told by Muller at least six times that Basic had in fact been approached regarding potential merger activities.

On Monday, December 18, Basic asked the Exchange to suspend trading because they had been "approached" concerning a possible merger. On December 19, Basic accepted Combustion's tender offer. On December 20, 1978, after the plaintiffs had sold their Basic shares, Basic announced its approval of a Combustion tender offer to buy all of Basic's outstanding shares at a price substantially in excess of that at which the plaintiffs sold their shares.

MATERIALITY

Section 10(b) of the Securities Exchange Act and Rule 10b-5 prohibit an issuer from making public statements that are untrue or, if literally true, are misleading because of material omissions. *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 860-862 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Rule 10b-5 states in part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

• • •

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

17 C.F.R. § 240.10b-5 (1984). These requirements insure that all investors have all relevant information for investment decisions and protect the basic integrity of the stock exchanges. *Rochelle v. Marine Midland Grace Trust Co.*, 535 F.2d 523, 532 (9th Cir. 1976).

Here the district court granted summary judgment for the defendants because it found the three statements at issue were not materially false or misleading in their denial of significant corporate developments. The court found that there were no negotiations occurring at the time of the first statement. It found the second and third statements were made while negotiations were occurring but that because these negotiations were not "destined, with reasonable certainty, to become a merger agreement in principle," they were not material. We find this reasoning flawed.

10b-5 cases begin with an analysis of whether a general duty to disclose exists. Then it must be determined whether the facts that the plaintiffs claim should have been disclosed were material. If the defendants were under a duty generally, and if the undisclosed facts were material, a violation has occurred if the other requisite 10b-5 factors such as scienter and reliance are also present. Here, we need not address whether Basic had a duty initially to disclose the contacts, discussions and information exchanges that were occurring with Combustion Engineering. An initial duty to disclose material merger negotiations exists only in certain limited circumstances. *See Starkman v. Marathon Oil Co.*, 772 F.2d 231 (6th Cir. 1985). Courts have held that a duty to disclose negotiations arises in situations, such as where the corporation is trading in its own stock, or where it is responsible for rumors of the discussions leaking into market. *See, e.g., Staf-*

fin v. Greenberg, 672 F.2d 1196, 1202-07 (3d Cir. 1982); *State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

However, a far more important duty to disclose arises when the corporation has made a public statement which would be misleading without disclosure of the merger discussions. If a corporation is not under a duty to disclose corporate information, but voluntarily chooses to make a statement and the statement is "reasonably calculated to influence the investing public" the corporation then has a duty to disclose sufficient information so that the statement made is not "false or misleading or . . . so incomplete as to mislead." *Texas Gulf Sulfur*, 401 F.2d at 862. *See, e.g., Etshokin v. Texasgulf, Inc.*, 612 F.Supp. 1220, 1227-29 (N.D. Ill. 1984); *Schlanger v. Four-Phase Sys., Inc.*, 582 F. Supp. 128, 133-34 (S.D.N.Y. 1984). *See also In re Carnation Co.*, Sec. Exch. Act Rel. No. 22214 (July 8, 1985) [1984-85] Fed. Sec. L. Rep. (CCH) ¶ 83,801.

Basic's duty to clarify and disclose the discussions arose only because of Basic's statements denying knowledge of "any present or pending corporate developments" when, as the record clearly illustrates, Basic was in contact with Combustion Engineering and merger discussions were occurring within the two corporations and between them. As officers and spokespersons for a publicly traded company, the employees of Basic had a responsibility and duty to be truthful. The discretion they possessed was in speaking at all; once they spoke they could not be patently untruthful. As we noted earlier, the record reveals numerous telephone calls between Basic and Combustion. Kelly, an officer of Combustion, visited Basic's headquarters frequently. The record illustrates that a merger of the two corporations was the purpose of these contacts and that the conversations focused on that topic.

These facts made Basic's denials of any knowledge of corporate developments that would cause high trading volume

in Basic stock misleading, if not totally false. Basic's statements were read narrowly by the district court to say that Basic did not *know* the reason for the unusual market activity. Yet, even if that proposition were true, in that Basic, for some reason, never knew the reason for the unusual market activity, the statements were misleading in that they could reasonably be read broadly by the public as flat disclaimers of any significant corporate developments that might account for the high volume stock activity.

Basic's statement that "no negotiations" were occurring was also misleading, if not patently untrue. Basic argues that the denial was technically correct because no discussions occurred which would satisfy the legal definition of "negotiations." The average investor does not necessarily know the technical and legal definition of these words as used by Basic. A statement that "no negotiations" were occurring could reasonably be read to state that *no* contacts of any kind whatsoever regarding merger had occurred. Because of the "Strategic Plan" of Combustion regarding Basic, had there been only one telephone call from Kelly to Muller, this statement would have been clearly untrue. Thus, the various denials by Basic were affirmative misrepresentations. Basic's silence following these misrepresentations is not the same as Basic's silence had Basic not made any statement. In these early stages of the discussions between Combustion and Basic, Basic had no duty to speak, but once it spoke, it assumed the legal duty to be truthful. *See, e.g., Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 379 (2d Cir. 1980).

Under Rule 10b-5, "[a] duty to speak the full truth arises when a defendant undertakes to say anything." *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1317 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978). For example, in *Schlanger v. Four-Phase Sys., Inc.*, 582 F. Supp. 128 (S.D.N.Y. 1984), a class of plaintiff shareholders brought an action against certain officers and directors of Four-Phase Systems. The plain-

tiffs claimed that the defendants had issued a public statement indicating that the company was "not aware of any corporate developments which would affect the market of its stock," *id.* at 129, when, in fact, merger negotiations were underway. The court stated:

While the federal securities laws do not impose a general duty upon an issuer to disclose material facts or new developments when it is not trading in its own securities, it does have a duty to make certain that any statement it does issue is truthful and complete, and does not materially misrepresent the facts existing at the time of the announcement. *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860-62 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); see also *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 853 (2d Cir. 1981). In this case, defendants *did* make an announcement, intended to be relied on by purchasers and sellers, and therefore had a duty to make a statement which was both truthful insofar as it went, and not misleading in light of the facts known at that time.

Schlanger, 582 F. Supp. at 133. See also *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 529-31 (7th Cir. 1985).

Having established a duty to disclose certain omitted facts, we must now determine whether those facts were material. As defined in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), an omitted fact is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." See also *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 225 (6th Cir. 1982). When a company whose stock is publicly traded makes a statement, as Basic did, that "no negotiations" are underway, and that the corporation

knows of "no reason for the stock's activity," and that "management is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity," information concerning ongoing acquisition discussions becomes material *by virtue of the statement denying their existence*. The "reasonable investor," having been informed that Basic knew of no corporate development that would result in the high trading activity, would, without doubt, have thought that disclosure of the fact that acquisition was being discussed "significantly altered the 'total mix' of information made available."

In *Holmes v. Bateson*, 583 F.2d 542 (1st Cir. 1978), a non-disclosure case, the plaintiff, an estate, sold its shares of Maguire Corporation to Maguire on January 6, 1970. *Id.* at 550. Maguire, as of that date, had had one expression of interest and had had preliminary discussions with two other companies. *Id.* at 546-50. The First Circuit found it "inconceivable that a reasonable stockholder would not think that the merger information concealed in this case was important and, therefore, material." *Id.* at 558. We, too, find it "inconceivable" that Basic stockholders would not find the fact that discussions were occurring between Combustion and Basic, in light of Basic's statements, to be important and, therefore, material to making normal reasonable investment decisions.

In contrast, a divided panel of the Third Circuit in *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (2d Cir. 1984), *cert. denied*, — U.S. —, 105 S.Ct. 1189 (1985), expressed a view with which we are in disagreement, holding in a similar fact situation that such a statement was not false or misleading. In *Greenfield*, Heublein was in the midst of merger negotiations but issued a statement that the company was unaware of any reason that explained the unusual activity in its stock. *Id.* at 754. The court stated that the management "clearly knew of information that might have accounted for the increase in trading." *Id.* at 759. However, the panel felt bound by earlier Third Circuit precedent and following *Staffin v.*

Greenberg, 672 F.2d 1196 (3d Cir. 1982), found the statement not false or misleading because the merger discussions were only preliminary. *Greenfield*, 742 F.2d at 755-59. The *Greenfield* court stated that the company's voluntary statement that it knew of no reason for heightened activity of the stock was not misleading because the merger discussions were not material and, therefore, their omission could not have been an "[omission] of a material fact" as prohibited by Rule 10b-5. *Id.* at 756-59.

We feel the *Greenfield* court's reliance on *Staffin* was clearly misplaced. In *Staffin*, Bluebird, Incorporated made a tender offer for its own shares on June 11, 1979. An officer of Bluebird, on July 11, discussed the possibility of acquisition with another company, Northern Foods, Ltd. *Staffin*, 672 F.2d at 1200-01. No statement was made by Bluebird that in any way touched upon the meeting of July 11. The plaintiffs in *Staffin* argued that these actions were an unlawful failure to disclose a material fact. *Id.* at 1205. Though the court did note that Bluebird was under a general duty to disclose because a tender offer was in progress, the court stated that preliminary merger discussions were immaterial as a matter of law. Therefore, nondisclosure of these immaterial facts could not be misleading. *Id.* at 1205-06.

The *Staffin* court's determination that preliminary merger discussions were not material as a matter of law was made in the context of whether any information needed to be initially and affirmatively disclosed. This determination of materiality is certainly not necessary in a posture similar to the one in *Greenfield* where a voluntary statement was made which was factually untrue. In analyzing whether information regarding merger discussions is material such that it must be affirmatively disclosed to avoid a violation of Rule 10b-5, the discussions and their progress are the primary considerations. However, once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material

because they make the statement made untrue.⁴ The *Greenfield* decision failed to note this difference of contexts.

Having disposed of the materiality issue, we turn now to the question whether the plaintiffs have offered sufficient proof that the other necessary elements to establish the 10b-5 violation are present. Because our ruling on materiality is contrary to that of the district court, we must vacate the summary judgment and remand the case to the district court for further consideration on these issues. We note that the district court, in dealing with the scienter issue, stated:

[T]his court has concluded that non-disclosure did not violate Rule 10b-5, because the information has not been found to be material. Hence, the act of non-disclosure cannot constitute proof of scienter, *i.e.*, that the defendants were engaging in either intentionally misleading the investment public or that nondisclosure was "highly unreasonable conduct" with reference to the investment public.

Scienter, a traditional element of a section 10(b) and Rule 10b-5 action, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), can be proven by a showing that the defendants issued false or misleading public statements with knowledge that those statements were false or misleading, or with reckless disregard as to their false or misleading character. *See, e.g.*, *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981); *Mansbach v. Prescott, Ball, & Turben*, 598 F.2d 1017, 1023-25 (6th Cir. 1974).

⁴In *Etshokin v. Texasgulf, Inc.*, 612 F. Supp. 1220 (N.D. Ill. 1984), plaintiffs claimed that officers of Texasgulf had been involved in merger negotiations at the time Texasgulf issued a statement denying any knowledge of a reason its stock was being traded actively. *Id.* at 1222. In ruling that summary judgment was improper, the court noted that the denials themselves as well as the trading activity were factors which should be considered in determining materiality. *Id.* at 1229.

Because summary judgment is generally inappropriate for issues of scienter, knowledge and intent, *see, e.g., Poller v. Columbia Broadcasting Sys., Inc.*, 368 U.S. 464, 473 (1962); *Smith v. Hudson*, 600 F.2d 60, 66 (6th Cir.), *cert. dismissed*, 444 U.S. 986 (1979), this issue must be first decided by the district court and may not be decided by us as a matter of law.

CLASS CERTIFICATION

The second major issue for us to resolve is the class determination made by the district court. Basic and the individual defendants claim that the district court erred in certifying the class of plaintiffs. The district court, in analyzing whether Rule 23 of the Federal Rules of Civil Procedure had been satisfied, found the requirement of Rule 23(b)(3) problematic. That rule provides, in part, that a class will be certified only if "the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members." Here the district court believed that if each of the members of this class, sellers of Basic shares between October 20, 1977, and December 15, 1978,⁵ were required to show reliance on the misrepresentations, questions affecting individual members probably would predominate over common questions such that the class certification would be improper. To circumvent what the district court perceived to be a barrier to class actions in 10b-5 cases, it applied a presumption of reliance so that common questions predominated and the class was appropriately certified. We agree.

Reliance is the element of a Rule 10b-5 action that establishes the causal nexus between the defendant's wrongful con-

⁵The district court excluded persons who had purchased shares after the October 1977 statement and sold before the September 1978 statement and also excluded persons who had sold shares after the close of the market on December 15, 1978.

duct and the plaintiff's injuries. *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). The clearest statement of the theory of presumption of reliance is found in Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143 (1982). In two distinct situations, where proof of actual reliance would be impractical or impossible, courts have applied the doctrine of presumption of reliance. Note, *The Reliance Requirement in Private Actions under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 589 (1975), *quoted in Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 717 (8th Cir. 1978). One situation involves non-disclosure of material facts in face-to-face transactions. *See Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). The other involves material public misrepresentations that distort the price of stock on the impersonal market, in other words, a fraud on the market. *See Note*, 95 Harv. L. Rev. at 1148-49.

The fraud on the market theory is based on two assumptions: first, that in an efficient market the price of a stock will reflect all information available to the public, *id.* at 1154 & n.44; and, second, that an individual relies on the integrity of the market price when dealing in that stock. *Blackie*, 524 F.2d at 907. When a defendant is shown to have made a material public misrepresentation that, if relied on directly, would fraudulently induce an individual to misjudge the value of the stock, the theory presumes that some investors did so rely and that the market price is distorted. When a plaintiff purchases on the impersonal market after these misrepresentations are made, the theory presumes that he relied on the supposed integrity of the market price, and thus indirectly on the misrepresentation. These two presumptions apply whether the misrepresentations would induce an overvaluing by a relying investor and thus an artificial inflation of the market price, or an undervaluing and a resultant artificial deflation.

In order to invoke the presumption of reliance based upon the fraud on the market theory, a plaintiff must allege and

prove five elements. A plaintiff must demonstrate (1) that the defendants made public misrepresentations, *Blackie*, 524 F.2d at 906, (2) that the misrepresentations were material, *id.* (3) that the stock was traded on an efficient market, Note, 95 Harv. L. Rev. at 1161, (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the stock, see *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982), and (5) that the plaintiff traded in the stock between the time the misrepresentations were made and the time the truth was revealed.⁶ *Blackie*, 524 F.2d at 906. We believe the record supports the allegations that relate to elements (1) and (2). The Basic stock was traded on an efficient market and the plaintiffs have sufficiently pled a sale of the stock during the relevant period (elements (3) & (5)). The only real question then is element (4)—whether the plaintiffs can prove that a reasonable investor who was aware of the defendant's statements would have undervalued the stock. The plaintiffs claim that the misrepresentations were intended to and did deflate the price of Basic's stock. This allegation satisfies element (4) for pleading purposes and should not be dismissed as a matter of law. See *Schlanger*, 555 F. Supp. at 538-39. If the plaintiffs are able to prove this and the other elements, it will be quite logical to presume that some investors relied on the misrepresentations resulting in a deflation of stock price and that members of the class relied upon the supposed integrity of the market price when selling their shares. The mere fact that the proof could be difficult does not preclude the opportunity to make the presentation at trial.

⁶A defendant can defend against this presumption of reliance in two ways. First, of course, a defendant can rebut proof of the five elements that give rise to the presumption. Second, a defendant can disprove the presumed facts by showing that "an insufficient number of traders relied to [distort] the price" or that "an individual plaintiff [traded] despite knowledge of the falsity of a representation, or that he would have, had he known it." *Blackie*, 524 F.2d at 906.

The fraud on the market theory has been consistently applied in cases in which the defendants made public, material misrepresentations and the plaintiffs transacted shares in an impersonal, efficient market. See *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, — U.S. —, 105 S. Ct. 814 (1985); *T. J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983); *Ross v. A. H. Robins Co.*, 607 F.2d 545 (2d Cir.), *cert. denied*, 446 U.S. 946 (1980); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). Here, the defendants made public, material misrepresentations and the plaintiffs sold Basic stock in an impersonal, efficient market. Thus the class, as defined by the district court, has established the threshold facts for proving their loss.

Cases in which application of the presumption of reliance has not been applied, are easily distinguished because they do not involve a public misrepresentation or an impersonal exchange in the open market. For example, this Circuit, in *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977), refused to apply the presumption of reliance. In *Fridrich* former shareholders of Old Line Life Insurance brought an action to recover against five insiders who had traded Old Line stock while in possession of material information about merger negotiations. None of the trades were directly with the plaintiffs. The duty to disclose arose from the insider trading. No public statements were made when the defendants traded in the stock, and, because the insider trading was secret, there was no way in which their wrongful acts could have affected market price. See also *Laventhall v. General Dynamics*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983) (insider trading, no public statement); *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978) (misrepresentations surrounding the initial offering of corporate bonds, a situation in which price is not a reflection of the transactions of investors).

The situation before us is clearly not analogous to these cases. Therefore the district court was correct in applying the presumption of reliance to this case to allow that the class be certified.

We reverse the summary judgment granted to the defendants on the section 10(b) and Rule 10b-5 issue; we affirm the Rule 23 class certification and remand the case to the district court for further proceedings.

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF OHIO

EASTERN DIVISION

C79-1220

MAX L. LEVINSON, et al.,

Plaintiffs,

—v.—

BASIC, INC., et al.,

Defendants.

MEMORANDUM AND ORDER

THOMAS, *Senior Judge*:

Defendants are Basic Incorporated (Basic) and Anthony M. Caito, Samuel Eells, Jr., John A. Gelbach, Harley C. Lee, Mathew J. Ludwig, Max Muller, H. Chapman Rose, Edmund Q. Sylvester and John C. Wilson. The individual defendants were directors of Basic before its merger with CEBAS, Inc., a wholly owned subsidiary of Combustion Engineering, Inc. (C-E). Muller, Ludwig and Caito were also, respectively, president (CEO), senior vice president of finance and administration, and executive vice president of refractories and chemicals of Basic. Plaintiffs Levinson, Zuckerman and Newman, who were stockholders of Basic, bring this class action under section 10(b) of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. § 78j, and Rule 10b-5, promulgated pursuant to section 78(w) of the 1934 Act. Defendants move for summary judgment.

The case was precipitated by Basic's merger with CEBAS, Inc., a wholly owned subsidiary of Combustion Engineering, Inc. Hereinafter, the tender offer will be treated as made by Combustion. On December 19, 1978, Basic's board of directors accepted CEBAS' tender offer to buy outstanding Basic common stock at \$46 per share and outstanding preference shares at \$104.55 per share. The board recommended the offer to the company's stockholders who approved. The plaintiffs had previously sold their stock.¹

Headquartered in Cleveland, Basic was a producer of basic refractory materials² and specialized chemicals. It also manufactured electronic products. Its refractory division marketed its raw dolomite for use in blast and open hearth furnaces and for other uses. In 1976-78, and before, Combustion Engineering was engaged in a broad range of industrial activities. It provided steam generating systems (fossil fueled and nuclear) and sold products to public utilities. It engineered and built chemical plants and oil refineries and produced equipment for the oil and gas industry. Its industrial products group produced specialty refractory products, as well as screening, building and mineral products.

James B. Kelly, Combustion Engineering secretary and a vice president between 1963 and 1973, became vice president in charge of the company's industrial products group (IPG) in

1. This court has certified a class comprising all Basic common stockholders who sold their common stock between October 21, 1977 and December 15, 1978.

2. Webster *Third New International Dictionary* (1971), thus defines a refractory material:

... any of various nonmetallic ceramic substances that are characterized esp. by their suitability for use as structural materials at high temperatures usu. in contact with metals, slags, glass, or other corrosive materials (as in furnaces, crucibles, or saggars), that are classified chemically as acid (as silica and fireclay), basic (as magnesite and dolomite), or neutral (as high-alumina refractories, carbon, and silicon carbide), and that are produced in the form of brick and other shapes, finely ground cementing materials, castable concretes, plastics, and granular materials in bulk. . . .

1975. At the November 18, 1976 meeting of Combustion's executive committee, Kelly differentiated the refractory products of Basic and Combustion:

He noted that, as its name implies, Basic manufactures refractories which are chemically basic, whereas the Company deals almost exclusively in alumina refractories which are chemically acid, or non-basic.

He explained:

[Combustion's] refractory products are based upon raw materials [mined by Combustion] with a high proportion of alumina and silica, are used in all applications where no contact with chemically basic materials exist, and are suitable only for lower temperature applications.

On the other hand,

the products of Basic . . . are based upon raw materials with a high proportion of magnesite [mined or produced from seawater], chrome or dolomite [mined], are significantly more expensive to manufacture and command significantly higher prices than alumina-based refractories, are used in melt applications where contact with chemically basic materials exists, and are especially suited for high temperature applications.

Rule 10b-5 of the 1934 Act, 17 C.F.R. § 240.10b, provides in part:

It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

• • • • •

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made in the light of the circumstances under which they were made, not misleading. . . .

In their "opposition" brief, plaintiffs thus synopsized allegations of their amended complaint of November 8, 1979:

In response to widespread rumors of merger activity and frenzied trading activity in Basic's stock, defendants issued three false and misleading public statements in which they falsely represented, and misleadingly suggested, that "no negotiations were under way with any company for a merger" and that there were "no significant corporate developments" to account for the activity in Basic stock.

In fact, defendants' public statements were false and misleading in that they falsely denied, and omitted to disclose, (1) that Basic was involved in active merger negotiations with Combustion Engineering, Inc. ("Combustion"), and (2) that Basic had prepared financial projections showing a dramatically changed financial picture for the company.

The three statements alleged to be false and misleading, set forth subsequently at pp. 55-56, 98, and 116, were made public, as follows: A statement published in the *Cleveland Plain Dealer* on October 21, 1977 (plaintiffs' Ex. 53); a press release of September 25, 1978 (plaintiffs' Ex. No. 64); and a statement which was included in Basic's "Nine Months Report 1978," dated November 6, 1978 (plaintiffs' Ex. No. 65) issued to shareholders.

In their amended complaint, plaintiffs allege in paragraph 32:

. . . Defendants knew that the investment community and the holders of Basic's securities believed or had reason to believe that there were some significant corporate developments which would affect the prospects for Basic. Basic issued these [three] statements with the intention of calming the market price of such securities at an artificially depressed level. . . .

Plaintiffs then allege that "[a]s a result of defendants' [three] false and misleading statements . . ., the market price of

Basic's Common and Preference Shares was artificially depressed. . . ."

Plaintiffs note that CEBAS' December 20, 1978 offer to purchase all of Basic's outstanding common shares for \$46.00 per share and all of Basic's outstanding preference shares for \$104.55 per share was "substantially in excess of the then market price of these securities." Plaintiffs assert:

Had plaintiffs not been fraudulently induced to sell their holdings of Basic securities by the [three] false and misleading statements . . ., they would have received such amounts upon the sale of their securities.

In seeking summary judgment, defendants argue that "the undisputed facts demonstrate" that the three statements at issue were neither false nor misleading. They assert that plaintiffs' allegations, "premised upon the possibility that contingent developments—a merger with C-E and earnings at levels indicated by favorable internal projections—would occur," are without foundation because

nothing in the record indicates that either of these possibilities was sufficiently definite at the time any of the statements was issued to require their disclosure.

In moving for summary judgment, defendants bear "the burden of showing conclusively that there exists no genuine issue as to a material fact . . . [T]he evidence together with all inferences to be drawn therefrom must be read in the light most favorable to the party opposing the motion." *Smith v. Hudson*, 600 F.2d 60, 63 (6th Cir. 1979), cert. denied, 444 U.S. 986 (1979). However, to successfully oppose a Rule 56 motion, a "party must present sufficient evidence supporting its claims to 'require a judge or jury to resolve the parties' differing versions of the truth at trial." *Smith v. Northern Michigan Hospitals*, 703 F.2d 942, 947 (6th Cir. 1983) (quoting *First National Bank of Arizona v. Cities Service Co.*, 391 U.S. 253, 286-290 (1968)). Under Rule 56(e), plaintiffs must rely on factual evidence in the record and cannot successfully oppose

defendants' motions with only the allegations in their pleadings.

Twenty-nine discovery depositions were taken. Thirteen of these were filed as part of the summary judgment record.³ The record also includes numerous deposition documentary exhibits, transcripts of testimony of four witnesses in the SEC investigation "in connection with the transactions in the securities of Basic, Incorporated, and other securities,"⁴ affidavits, answers to interrogatories, plaintiffs' amended complaint, answer of Basic, Inc. and answer of individual defendants to the amended complaint. Unless herein excluded as inadmissible, the facts used from the deposition or SEC transcript testimony, the affidavit statements or the deposition documentary exhibits will be deemed to be admissible in evidence.⁵ Only undisputed evidence is considered. Reasonable inferences of fact are also taken into consideration. Briefs of the parties and post-submission letters of counsel citing additional legal authorities have also been considered.⁶

3. Of the 20 depositions taken by the plaintiffs 13 are filed. None of the nine discovery depositions taken by defendants or plaintiffs and other persons have been filed.

4. Nineteen transcripts of SEC testimony were produced to plaintiffs consistent with court instructions.

5. At any trial, the parties would be permitted to assert objections and obtain rulings thereon with respect to the admissibility of evidence pursuant to the Federal Rules of Evidence. When ruling on a motion for summary judgment, a court "has discretion to disregard those facts which would not be admissible in evidence, and to rely on those facts which are competent evidence." *Wimberly v. Clark Controller Company*, 364 F.2d 225, 227 (6th Cir. 1966). To manage and control treatment of the voluminous record, the court comments on some but not all of the evidence submitted.

6. Plaintiffs submit public statements which other companies have issued. Of course, without going into the circumstances surrounding the issuance of the public statements reproduced in Exhibit G, it would be impossible to determine whether any of those statements were issued under circumstances similar to those present in this case. In any event, it is concluded that the conduct of other companies is not appropriate to be considered as evidence in the present case.

I.

A.

This is not a case involving insider trading. There is no evidence in the record that Basic or any of the individual defendants made open market purchases of Basic stock during the period at issue. In *Fridrich v. Bradford*, 542 F.2d 307, 318 (6th Cir. 1976), the Sixth Circuit stated:

The duty to disclose . . . is not an absolute one, but an alternative one, that of either disclosing or abstaining from trading. We conceive it to be the act of trading which essentially constitutes the violation of Rule 10b-5, for it is this which brings the illicit benefit to the insider, and it is this conduct which impairs the integrity of the market and which is the target of the rule. *If the insider does not trade, he has an absolute right to keep material information secret. SEC v. Texas Gulf Sulphur Co.*, [401 F.2d 833, 848 (2d Cir. 1968)], [hereafter TGS]. Investors must be prepared to accept the risk of trading in an open market without complete or always accurate information. [Footnote omitted; emphasis added.]

Hence, because there was no insider trading in this case, neither *Fridrich* nor other insider trading cases are applicable or controlling.

SEC v. Texas Gulf Sulphur Co., *supra* (hereinafter TGS), holds that

Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media, *Fleischer, supra*, 51 Va.L.Rev. at 1294-95, if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.

Id. at 862. However, the court added

that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated.

Staffin v. Greenberg, 672 F.2d 1196, 1204 (3d Cir. 1982), paraphrases this language to mean that "a corporation which makes a public statement about material corporate events has a duty to make the statement complete enough so as not to be misleading."⁷

The Third Circuit in *Staffin* upheld summary judgment granted to defendants on the issue of their failure to disclose preliminary merger discussions. In that case, defendant Greenberg's purchase of stock of Bluebird, Inc. from 1973 to 1979 led to his filing with the SEC a Schedule 13D statement revealing his intention to continue his purchases. On March 9, 1979, he filed an amendment indicating his intentions to file notifications as required by the Hart-Scott-Rodino Antitrust Improvements Acts of 1976, 15 U.S.C. § 18a. Efforts of Cook, the chief executive officer, and other members of management to find a "white knight," including possibly Northern Foods, Ltd., halted when Cook signed an agreement on March 27, 1979 with Greenberg conveying all but 100 shares of Cook's stock to Greenberg, giving Greenberg control of Bluebird. Bluebird publicly disclosed the sale when concluded, and this corporate event was not an issue in the case.

After Greenberg refused to buy out two directors who owned large blocks of stock, he decided that Bluebird should make a tender offer. Bluebird offered to buy 750,000 of its own shares at \$10 per share "to facilitate the liquidation of the holdings" of the two directors. In June 1979, Cook requested

that Greenberg give him his job back as C.E.O. Greenberg rehired him.

Bluebird's tender offer began on June 11, 1979. The tender offer materials "fully disclosed the financial situation of the company, Greenberg's controlling interest, the price he paid for that controlling interest, the desire of the two directors to reduce their holdings and Cook's return as chairman of the board and chief executive officer."

During the tender offer, Cook called Haskins of Northern Foods to discuss Cook's pre-planned trip to Europe. Without the knowledge of Greenberg or anyone else at Bluebird, Cook met on July 12, 1979 with Northern's management and "discussed the possibility of Northern's acquiring Greenberg's controlling interest." On July 23, 1979, Cook, by phone, was asked to arrange a meeting with Greenberg. While surprised to learn on July 25 of Northern's interest, Greenberg later agreed to meet in mid-August with Northern's representatives. When trading in Bluebird stock "jumped dramatically" in the first week of August, Bluebird became fearful "that word of the planned merger discussions had leaked to the market." On August 7, 1979, it issued a press release "saying that 'exploratory talks' were scheduled with an undisclosed purchaser."

Immediately thereafter, four Rule 10b-5 class actions were filed by stockholders, and two separate classes were certified.⁸ Plaintiffs claimed various Rule 10b-5 violations. However, the claim relevant to the instant case is that during the tender offer, Cook and Bluebird should have disclosed Cook's July 23 conversation with Mr. Haskins of Northern, as well as later preliminary merger discussions.

The Third Circuit recognized that since "[b]oth Rule 10b-5 and section 14(e) make unlawful a failure to disclose any 'material fact,' in connection with the purchase or sale of any securities," it was undisputed "that Bluebird was under a duty of disclosure, generally, during the tender offer." *Id.* at 1205.

7. However, the Third Circuit went on to say:

[T]he plaintiffs have not called our attention to any case, including TGS, which imposed any duty of disclosure under the Federal Securities Laws on a corporation which is not trading in its own stock and which has not made a public statement.

8. The court certified one class of shareholders who sold in response to the 1979 tender offer, and a second class of shareholders who sold their stock in the open market between May 29, 1979 and August 7, 1979.

Proceeding to the question of the materiality of the preliminary merger discussions, the court observed that, "eight courts have concluded that it is not necessary to disclose, in connection with a purchase or sale of securities, the occurrence of preliminary merger discussions."⁹ *Id.*

The Third Circuit stated that "[t]he reason that preliminary merger discussions are immaterial as a matter of law is that disclosure of them may itself be misleading, [citing *Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d at 1084-85]." *Id.* at 1206. The *Staffin* court quotes from testimony regarding "takeover bids, that is, cash tender offers" presented to the Senate Subcommittee on Securities of the Committee on Banking and Currency.¹⁰ The court noted that

9. The cases are *Missouri Portland Cement Co. v. H K Porter*, 535 F.2d 388, 398 (8th Cir. 1976); *Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075 (5th Cir. 1970); *Bucher v. Shumway*, [1979-80] F.Sec.L.Rep. (CCH) ¶ 97142 (S.D.N.Y. 1979), *affirmed*, 622 F.2d 572 (2nd Cir. 1980), *cert. denied*, 449 U.S. 841 (1980), *List v. Fashion Park, Inc.*, 227 F.Supp. 906 (S.D.N.Y. 1964), *affirmed*, 340 F.2d 457 (2nd Cir. 1965), *cert. denied*, 382 U.S. 811 (1965); *Berman v. Gerber Products Co.*, 454 F.Supp. 310, 318 (W.D.Mich. 1978); *Scott v. Multi-Amp Corp.*, 386 F.Supp. 44, 65 (D.N.J. 1974); *Crane Co. v. Aniconda Co.*, 411 F.Supp. 1208, 1210 (S.D.N.Y. 1975). But see *Levin v. Marder*, 334 F.Supp. 1050 (W.D.Pa. 1972).

10. *Staffin*, at 1206, quotes the following:

Obviously a company intending to make a tender offer strives to keep its plans secret. If word of the impending offer becomes public, the price of the stock will rise towards the expected tender price. Thus, the primary inducement to stockholders—an offer to purchase their shares at an attractive price above the market—is lost, and the offeror may be forced to abandon its plans or to raise the offer to a still higher price. The cost of an offer to purchase hundreds of thousands of shares might prove prohibitive if the price had to be increased only a few dollars per share. . . .

To insure secrecy and avoid leaks and rumors and because the relationship between the tender price and the market price is so critical, tender offers are normally made to stockholders immediately after a decision to make the offer is reached and a price has been determined. In spite of all precautions, there have been cases where tender offers have been preceded by leaks and rumors which caused abnormal market problems.

(footnote continued on following page)

the Williams Act, amended largely in response to such testimony, "contemplates public disclosure in filing with the SEC only after a tender offer is initiated." *Id.* See 15 U.S.C. 678n(d)(1). The court also quotes from the American Stock Exchange Manual at 104. The quotation ends with the statement:

In the course of a successful negotiation for the acquisition of another company, for example, the only information known to each party at the outset may be the willingness of the other to hold discussions. Shortly thereafter it may become apparent to the parties that it is likely an agreement can be reached. Finally agreement in principle may be reached on specific terms. In such circumstances, a company need not issue a public announcement at each stage of the negotiations, describing the current state of constantly changing facts, but may await agreement in principle on specific terms.

Id. at 1206-07. The Third Circuit then concluded:

Those persons who would buy stock on the basis of the occurrence of preliminary merger discussions preceding a merger which never occurs, are left "holding the bag" on a stock whose value was inflated purely by an inchoate hope. If the announcement is withheld until an agreement in principle on a merger is reached, the greatest good for the greatest number results. If the merger occurs, all of the company's shareholders usually benefit; if no merger agreement is reached, the stock performs as it would have in any event.

Id. at 207 (footnote omitted).

(footnote continued from previous page)

Transcript, Hearings Before the Subcommittee on Securities of the Committee on Banking and Currency, U.S. Senate, 90th Cong., 1st Sess., S. 510, p. 72, March 22, 1967, statement of Mr. Calvin on behalf of the New York Stock Exchange, Inc. See also New York Stock Exchange Co. Manual at A-19-20.

Concluding that a duty to disclose does exist where an "agreement in principle has been reached," the court determined that "the district court correctly granted summary judgment to the defendants on the issue of their alleged failure to disclose the occurrence of preliminary merger discussions."

Primarily citing *Staffin v. Greenberg, supra*, at 1206, the Second Circuit in *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983), observed that "since [merger] negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty," therefore, "[d]isclosure may in fact be more misleading than secrecy so far as investment decisions are concerned." *Id.* at 14.¹¹

B.

In considering plaintiffs' contentions with reference to each of Basic's three public statements, it is essential to determine whether any contacts between Combustion Engineering and Basic, which preceded the particular statement under consideration, represented preliminary merger discussions, imminent

11. Plaintiffs cite *S.E.C. v. Geon Industries, Inc.*, 531 F.2d 39 (2nd Cir. 1976), to support their contention that

the courts have repeatedly held that merger or tender offer discussions are of such significance to investors that even preliminary discussion, "nascent negotiations" and serious "approaches" have repeatedly been held to be highly significant, and clearly material, to the "reasonable" investor.

The *Geon Industries* court held that "the proposed Burmah transaction was sufficiently material that Rule 10b-5 prohibited disclosure by an insider [to a friend]. *Id.* at 48. However, the court noted that its holding was "limited to disclosure (or use) of inside knowledge of negotiations with respect to the type of merger which will result in a company's ceasing to exist as such, without implication what other transaction should invoke so severe a rule." *Id.* *Geon*, an insider case, cannot be presently applicable. Nor are other cited cases (insider cases) found to be applicable. Thus, *Staffin* referred to *Thomas v. Duralite Co., Inc.*, 524 F.2d 577, 585 (3d Cir. 1975), as an example of a case where liability may attach "to a failure to disclose discussions which have not reached an agreement in principle." The *Staffin* court noted that in *Thomas* "this court upheld a finding of liability on the part of an insider who intentionally suspended discussions that had already created the 'likelihood of a merger.'"

merger negotiations, or a merger agreement. *Black's Law Dictionary* defines the word "negotiation" as

[t]he deliberation, discussion, or conference upon the terms of a proposed agreement; the act of settling or arranging the terms and conditions of a bargain, sale, or other business transaction.

65A *Corpus Juris Secundum*, pp. 1078-79, defines the word "negotiate." While the term may be used in the sense of "sell[ing] or discount[ing] negotiable paper," the second and more general meaning is its use "in connection with the consummation of business transactions."

Corporate events of Basic beginning with the meeting between Muller, Ludwig, Caito of Basic and Kelly of C-E on November 27, 1978, up to and including Basic's acceptance of Combustion's tender offer on December 19, 1978, provide a real-life measure of comparison for earlier corporate events.¹² In his memorandum to file (file memo)¹³ of November 27,

12. Basic's intent to merge with Combustion at several times in 1976, 1977 and 1978 (prior to the November-December 1978 period) is claimed by the plaintiffs. Since Basic actually merged with Combustion in the November-December 1978 period, corporate events during this latter period provide highly relevant proof of Basic's corporate intent in the earlier years. However, these later corporate events are not considered as proof to show that the earlier corporate events were or were not material with respect to disclosure under Rule 10b-5.

13. Mr. Kelly testified that it was his normal practice

if something of significance happened, . . . to write this out in longhand on my way back from a meeting in the company plane, give it to my secretary that day if I arrived that day, or the next day, and have her type it up.

Similarly, Mr. Muller prepared what he called "a memory crutch, memory crutch chronology on Combustion Engineering" (herein memory crutch), and on other companies. He agreed that he maintained such a chronology "for significant corporate developments." The entries were "not contemporaneous but essentially following." For example, the entry of a meeting of June 20, 1978 was made "within two weeks." Mr. Muller also maintained a diary in which some meetings with Mr. Kelly were entered.

It is concluded that the practice followed by Kelly clearly brings his file memos within Rule 803(6) of the Federal Rules of Civil Procedure as records

1978, Kelly noted that he had met that morning in Cleveland with Muller, Ludwig and Caito. He told them:

We had not been back to them since this summer because . . . the relative low P/E [price to earnings ratio] of CE stock made a stock-for-stock transaction unattractive to CE. An appropriate multiple for Basic over market price would result in dilution for CE.

Kelly suggested "part cash (49 percent or less) and balance [in] securities be considered." He suggested a price of \$35. He noted, "they didn't reject such a number but felt the price too low compared with market history over the last six months." He said that they did not believe "the market price high in relationship to their current earnings outlook of close to \$5 per share." Further they stated:

They are not operating at a high market level because of merger rumors. They thought the better market performance resulted from their good earnings performance and prospects and the recognition of the fact that their mineral reserves are substantially undervalued. They stated that they had never heard any rumor about acquisition by CE.

In the final paragraph of the file memorandum, Kelly noted that "[w]e left the meeting with an action program on their part which would be a review of whether cash or cash plus securities would be acceptable to them." The file memo concluded:

If so, they would speak to Kidder Peabody for advice. The next step after that might be a meeting between

"in any form, of acts, events . . . opinions . . . made at or near the time by . . . a person with knowledge" and "kept in the course of a regularly conducted business activity."

Muller's memory crutch was likewise such a record "made . . . near the time by . . . a person with knowledge" and "kept in the course of a regularly conducted business activity. Both Kelly's file memos and Muller's memory crutch entries are determined to be admissible at trial.

Kidder, Peabody and First Boston to see if the bankers could agree on values.

Although more abbreviated, Muller's memory crutch of the November 27, 1978 meeting conforms to the content of Kelly's file memo. The crutch ended with the statement, "We told K. that we will ask Kidder-Peabody to assist us. K. proposed the possibility of 1st Boston (C-E's banker) to meet w. Kidder P."

It is evident that in their meeting of November 27, Kelly of C-E reaffirmed C-E's interest in acquiring Basic, an interest that was last expressed in the "summer," as Kelly noted. However, the conversation of November 27 did not involve a give and take bargaining, indicative of "negotiations." Kelly mentioned a combined stock and cash offer and suggested \$35 per share, and Muller, Ludwig and Caito did not reject the price out of hand. As Kelly put it, the parties "left the meeting" with Basic to see if "cash or cash plus securities would be acceptable." If acceptable to Basic, Kidder, Peabody (Basic's investment banker) and First Boston (C-E's investment banker) would then meet to "see if the bankers could agree on values."

First Boston prepared material for Combustion Engineering dealing with Basic, Inc. Kelly received the First Boston report dated December 7, 1978. He also received material prepared by First Boston for C-E on December 13 and 14, 1978.¹⁴

On December 14, 1978, the executive committee of Combustion Engineering met with Kelly, vice president of the industrial products group, two other company officers and representatives of the First Boston Corporation. Kelly commenced the discussion by stating "that recent conversations with the management of Basic indicated that Basic might well be receptive to receiving an acquisition offer from the company." After noting he had made presentations at executive committee

14. In his SEC testimony, Kelly testified that he did not think that First Boston "offered anything until probably the 13th of December. The first team never got on to this thing." These mid-December materials revised July 1978 materials of First Boston.

meetings of November 18, 1976 and July 27, 1978, he "gave an up-dated presentation with respect to the business of Basic and its sales, earnings, assets and net worth." First Boston's representatives (Perella and Wasserstein) "gave their views with respect to the price at which it would be appropriate for the Company to consider the acquisition of Basic." The executive committee then resolved that "proper officers of the Company" were "authorized to negotiate for and acquire . . . any and all of the capital stock of Basic, Incorporated ('Basic'). . . ." It was further resolved that "the price to be paid for the capital stock of Basic shall not exceed \$46 per common share; and provided, further, that the acquisition hereby authorized, be acceptable to the management and directors of Basic."

The minutes of the executive committee meetings of November 18, 1976 and July 27, 1978 each stated:

It was the sense of the meeting that the management of the Company should continue to proceed with its investigations, preparations and, as appropriate, negotiations with respect to the possible acquisition of Basic.

The effective difference between the executive committee's action at these earlier meetings and at the meeting of December 14, 1978 is that on the latter date for the first time the executive committee authorized the company's proper officers "to negotiate for and acquire" all of Basic's capital stock. Moreover, for the first time the executive committee fixed a price to be paid for the capital stock of Basic, capped at \$46 per common share. Also, by its resolution, the executive committee authorized "the President, any Vice President, any Assistant Secretary, the Assistant Treasurer, and any Assistant Controller . . . to execute and deliver any purchase agreement, merger agreement . . . or other agreement or document in furtherance of or in connection with the proposed acquisition." Previously, the executive committee had not bestowed on particular officers authority to enter into a merger or acquisition agreement with Basic, Inc.

Kidder, Peabody & Co., Inc. was Basic's investment banking firm. By letter agreement prepared and executed by its assistant vice president Parker on February 9, 1978 and signed by Muller, president of Basic, Inc., on March 14, 1978, Basic employed Kidder, Peabody for a six-month period which dated from November 16, 1977 "to assist Basic, Incorporated (the 'Company') as financial advisor." The agreement was extended for an additional six months starting May 16, 1978. By Basic's letter of November 13, 1978, acknowledged on November 27, 1978 by Parker of Kidder, Peabody, Basic elected "to continue the financial advisory arrangement at the current fee of \$10,000 [through May 15, 1979]."

Kidder, Peabody's role and responsibility as Basic's investment banker was greatly enlarged in mid-December. Martin Siegel of Kidder, Peabody, in his SEC testimony, recalled that in "the beginning of December of 1978 he received a telephone call from Mr. Ludwig who indicated that he would like me to come out to Cleveland to meet with the company." When Siegel asked him "what would he like to talk about," Ludwig said, "we'll tell you when you get here." He recalled that "around the 13th or the 14th" he "went out to Cleveland."¹⁵ At a meeting with them, he "was informed that the company had had an approach made to it by Combustion Engineering and that Combustion Engineering had indicated that at one meeting . . . that they may be interested in acquiring Basic at possibly thirty-six dollars a share."

Ludwig's diary shows that Siegel met with Muller, Ludwig and Caito on Thursday, December 14 from 3:30 p.m. into the evening. While Ludwig had no recollection that this meeting related to the possibility of an acquisition of Basic by Combustion, Siegel's testimony makes it clear that this was the subject of the meeting. Ludwig's diary further indicates that on December 15 between 9:00 a.m. and 10:00 a.m., two telephone

15. Geoffrey S. Parker, vice-president of corporate finance of Kidder, Peabody, recalled that Marty Siegel "went out to Cleveland on Thursday, December 14, on or about that day." His calendar indicated that he (Parker) was "at Basic on Monday and Tuesday, December 18th and 19th."

calls were made to Siegel at the Bond Court Hotel. Concerning Siegel's visit to Cleveland, Ludwig stated that Siegel was to "produce an evaluation of the Basic stock in a very short period of time, like three, four, five days" because of a "planned visit by Mr. Santry, President of Combustion, on the 19th of December." He stated that the purpose of Santry's visit was "to make an offer to Basic." As will be seen, Kelly communicated this fact in his telephone conversations with Muller of December 14 and 15.

Siegel's testimony is consistent with Muller's recollection that "the first time [that Muller] talked to Kidder, Peabody about Combustion Engineering specifically, was either December 14th or 15th," and to his knowledge no one at Basic had "discussed Combustion specifically with Kidder, Peabody prior to that time." That Muller first disclosed to Kidder, Peabody that Combustion Engineering was interested in acquiring Basic on December 14 or 15, is congruent with the content of the Kidder, Peabody-Basic letter agreement dated December 15, 1978.¹⁶

While the letter agreement does not refer to Combustion Engineering as the likely offeror seeking to acquire Basic's stock or assets, the content of the agreement anticipated that some company would be making an acquisition offer. As the second paragraph states:

We are submitting this letter to confirm our understanding that Kidder, Peabody has been retained to assist the Company as financial advisor with respect to any indications of interest in, or proposals or offers for, the acquisition or sale of the stock or assets of the Company, by or to any other party or parties. In consideration for such

16. Muller initialed a strike-out on page 1 of the agreement on December 19, 1978, but Muller's execution of the agreement is undated. Since vice president Siegel executed the agreement for Kidder, Peabody, he undoubtedly prepared it on December 15, the date of the agreement. Ludwig's two telephone calls to him at the Bond Court Hotel on December 15 may in part have related to the preparation of this agreement.

services, the Company agrees to pay us a retainer fee of \$75,000.

Following the meeting of Combustion Engineering's executive committee authorizing the identified officers to offer to acquire all of Basic's capital stock, Kelly called Muller to arrange for Santry to come to Cleveland to make an offer to him. Indicating that Muller was not in favor of that approach, Kelly quoted Muller as stating that "[h]e thought that our action program was for the bankers to get together and over some extended period of time work out an acceptable price." Muller turned down the proposed December 15 meeting with Santry. After a series of telephone calls, Muller on the evening of December 15 Muller agreed to meet with Messrs. Santry and Kelly on Tuesday, December 19.¹⁷ Significantly, Muller's memory crutch regarding "10:00 a.m. visit by Jim Kelly, MJL, AMC, MM," states, "discussed details—but *not* price." Muller's rejection of Kelly's proposal to have Mr. Santry and Kelly come to Cleveland on December 15 to make an offer and Muller's reminder to Kelly that the "action program was for the bankers to get together and over some extended period of time work out an acceptable price," coincided with both Kelly's file memo and Muller's memory crutch recording the conversation of November 27, 1978. Consistently, Kidder, Peabody's December 15 letter agreement obligated Kidder, Peabody to "promptly begin to review various factors to be considered with respect to a potential merger transaction, and,

17. Consistent with Kelly's SEC testimony, Muller testified at the SEC hearing that Kelly had agreed to postpone the Santry meeting from December 15 or 16 for several days. He also testified that he agreed to meet with Kelly one day before Santry's visit. Messrs. Kelly, Muller, Ludwig and Caito met on Monday morning, December 18. Ludwig's diary indicates this meeting took place between 11:00 and 12:00 in the morning and that he and Kelly had lunch together. Also, his diary shows that from 7:00 a.m. to 9:00 a.m., Muller, Caito, himself, G.C. (Collins) and D.Y. (Davis Young) met to prepare a release. Ludwig, David Gunning (Jones, Day attorney) and he met regarding "halt trading [of Basic stock on the New York Stock Exchange]."

if appropriate, assist the company in negotiations leading toward such a transaction."¹⁸

From December 15 through December 19, 1978, Kidder, Peabody carried out its obligations under the new contract of December 15 on two fronts: (1) "promptly [began] to review various factors to be considered with respect to a potential merger transaction;" and (2) "assist[ed] the company in negotiations leading towards such a transaction."

Relating to the second responsibility, the SEC testimony of vice president Siegel discloses his negotiations with Bruce Wasserstein of First Boston Corporation, C-E's investment banker. He remembered getting a call at his hotel room from Bruce Wasserstein who had traced him down. He informed Siegel that "his client was very much interested in acquiring Basic." Siegel states that he told Wasserstein "that timing was always a function of price." Wasserstein said that he would get back to him. After noting the "unusual trading activity in the stock," Siegel said that he suggested that the rest of the corporate finance team (Parker, Brown and Rodgers) "come out and make sure they were fully up to date on the company and its prospects and valuations, so that if we had to analyze an offer, we'd be fully qualified to do so."

While observing that Wasserstein of First Boston continued to call him, Siegel testified that "no offer had been made; an indication of interest had been made, but no offers had been made." Siegel told Wasserstein that his client "would seriously consider any indication, but the \$36 number that had been

18. The paragraph concluded:

In the event of the consummation of a transaction or transactions whereby the stock or assets of the Company are acquired, whether by purchase, acquisition, merger, consolidation or otherwise, the Company agrees to pay to Kidder, Peabody a fee, which together with the aforementioned \$75,000 will equal 1 1/4 percent of the aggregate value of the consideration received by the stockholders of the Company in any transaction or transactions, payable in cash upon the closing or consummation of such transaction or transactions.

thrown out on the table was patently ridiculous."¹⁹ Asked "what would it take to do a deal," he informed Wasserstein to make an offer, and Basic would decide "whether or not we think that offer is adequate and if it's adequate and the board approves it, then there'll be a transaction." Further discussion led to the question, "would an offer of, I think 42 or 43 be adequate?" Noting that he remembered numbers better than he remembered the exact conversations, Wasserstein came back and said, "45, would this be an appropriate number?" Siegel replied:

[W]ell, you're starting to get up into the range of where I think, you know, we would be able to say this thing is certainly adequate, but you're going to have to do better than 45 if you want acquiescence on the part of my client, again having advised my client throughout this.

The Wasserstein-Siegel conversations ended with Wasserstein stating, "We'd like to have a meeting set up between our client, Combustion,—I forget the name of the head of Combustion—and your client and could he come out to Cleveland and meet with him, and I think that was on a Monday afternoon or a Tuesday"

Bearing in mind the undisputed statement in Kelly's file memo of November 27, 1978 that he "suggested \$35," and

19. In Siegel's meeting of December 14 with Basic management, he was informed that "the company had had an approach made to it by Combustion Engineering and that Combustion Engineering had indicated . . . that they may be interested in acquiring Basic at possibly thirty-six dollars a share . . . they had indicated to me that they thought perhaps that now was the time to sell, that they, for various reasons, thought this would be a very useful merger between the two." (According to Kelly's file memo, he "suggested" \$35 per share.) Siegel continued, "Having gone over the numbers in the files . . . and . . . as to the current state of our understanding of the valuation of the company, I indicated to them that I thought the thirty-six dollar price was not an adequate price and that if they wanted to sell, they could certainly do much better than that. Asked "what I thought a good valuation for the company would be . . . I said that at least forty dollars a share in terms of valuation and possibly as high as forty-five. We didn't discuss tax free versus taxable."

Muller, Caito and Ludwig "didn't reject such a number," and the further undisputed entry in Muller's memory crutch that price was not discussed in the December 18 meeting with Kelly, the undisputed facts of record require these conclusions:

1. Since the executive committee of Combustion Engineering had authorized an acquisition price of "not exceed[ing] \$46 per common share," it is apparent that Combustion Engineering, with First Boston's help, would have closed a deal at less than \$46 per common share "if acceptable to Basic." The minutes did not direct the indentified officers to make a tender offer in the exact amount of \$46 per common share. Instead, the minutes of the executive committee authorized the identified officers "to negotiate for and acquire" the capital stock of Basic, Inc. at a price that "shall not exceed \$46 per common share."

2. C-E president Santry's offer on December 19, 1976 of \$46 per common share directly resulted from a bargaining over price, the principle term of the eventual merger agreement. Thus, negotiations were carried on between First Boston and Kidder, Peabody between December 15 and December 19, 1978. No negotiations leading to this price had been previously carried on between the identified officers of Combustion Engineering and Basic Management.

3. No tender offer price, authorized by the Combustion Engineering executive committee, was communicated to Basic until Santry made the \$46 per common share offer on the morning of December 19. Basic's informal acceptance of that price was communicated to Santry by Muller, but formal approval was by resolution of Basic's board of directors at its special meeting which commenced later on December 19. The Board's minutes indicate that Muller summarized the terms of the proposed acquisition "which would be accomplished by a tender offer for all of the Common and Preference Shares of Basic at \$46 and \$104.55 in cash, per share, respectively." Muller then asked Martin Siegel of Kidder, Peabody "to report on the conclusions of his firm concerning its valuation of Basic

and its evaluation of the Combustion Engineering offer." The minutes then state:

Mr. Siegel and his colleagues distributed copies of their report to the Board, reviewed the history of the relationship between Kidder, Peabody and Basic and summarized the detailed valuation materials in the report. In summary, Mr. Siegel stated that in the opinion of his firm, the offer from Combustion Engineering was fair and equitable from a financial point of view.

4. Hence, it was not after president Santry of CE presented C-E's offer to acquire all stock of Basic at \$46 per common share and \$104.55 per preference share, the price to be in cash, and later on December 19, the board of directors, by resolution, accepted the tender offer, was it true that an agreement was consummated. Earlier that day, Muller's informal acceptance of the Santry offer of \$46 per common share may be characterized as "an agreement in principle."²⁰

Unusual trading activity in Basic's stock occurred on Friday, December 15. Before trading began on the morning of December 18, 1978, Basic issued the following press release:²¹

BASIC INCORPORATED APPROACHED FOR MERGER

Cleveland - Basic Incorporated, Cleveland, Ohio, said today that it has been approached by a company indicating an interest in acquiring Basic. A spokesman for Basic

20. The resolution of the board of directors refers to "the agreement among the company, Combustion Engineering, Inc. and CEBAS, Inc. ("the agreement") in the form presented to this meeting." The resolution further stated that "with such changes or additions as may be approved by the president or senior vice president ["the agreement"] is hereby authorized and approved."

21. As Ludwig's diary reflects, the meeting concerning the press release occurred beginning at 7:30 a.m. on December 18. This was followed by a discussion with David Gunning of Jones, Day concerning halting trading.

pointed out that no offer has yet been made and that the other company has stated that it would only proceed on a basis acceptable to it and to the management of Basic. Basic stressed that while a meeting has been scheduled for Tuesday with representatives of the other company, it would be premature for Basic to speculate on the possibility of any transaction taking place. The New York Stock Exchange has temporarily halted trading in Basic stock. Basic said that it would not have any further comment prior to Wednesday.

While the public release was made before an offer to acquire Basic had been made, as the release stated, Basic had been "approached by a company indicating an interest in acquiring Basic." Basic also then knew that Santry, president of Combustion Engineering, was authorized by his executive committee to come to Cleveland on Tuesday, December 19, to make an offer to acquire Basic. While not mentioning the name of the company, the release stated that "a meeting has been scheduled for Tuesday with representatives of the other company." The release further announced that the other company had stated "that it would only proceed on a basis acceptable to it and to the management of Basic." Noting that "it would be premature for Basic to speculate on the possibility of any transaction taking place," the release further noted that "[t]he New York Stock Exchange has temporarily halted trading in Basic stock."

Thus, only after Basic (1) knew that Combustion Engineering's executive committee on December 14 had formally authorized the acquisition of Basic; (2) knew that CE's president on December 19 would be making an offer to acquire Basic; and (3) knew through the negotiations of Kidder, Peabody's Siegel with First Boston's Wasserstein that CE's offering share price was likely to be acceptable to Basic, did Basic on December 18 release the foregoing public statement.

II.

A.

In September or early October of 1976, Kelly called Muller to "renew contacts" and to set up a meeting in Cleveland.²² At the meeting Kelly indicated that Combustion was interested "in talking with [Basic] about a possible acquisition." Kelly reported that, as always, Muller responded that Basic "did not want to have any discussion on the negotiations on the acquisition" and that Basic was "interested in staying independent at the time."

A letter of October 18, 1976 from Kelly to Muller indicates that in a telephone conversation Kelly had asked Muller to provide C-E with a breakdown of Basic's "Ceramic Sales." Endorsed on the letter is a note of November 1, 1976, from Muller to Kelly, stating that the 1975 figures were then sent, with directions to "keep [them] confidential."

Plaintiffs note that "between September and December, 1976 . . . Kelly made several trips . . . to Basic's offices in Cleveland to meet with Muller and Ludwig." A Basic report, "Recent Interest in Basic," recorded this interest of Combustion Engineering in September-December 1976:

Several visits by Jim Kelly, V.P. of industrial division. CE lawyers anticipate no opposition from "Anti-trust," since CE is not now in "Basic" products. Jim Kelly will visit Cleveland at 9:30 Jan. 12.

Eight other companies were listed on this report. At the top of this and all "Recent Interest in Basic" reports appeared the statement, "MM's position: Basic is not for sale but in the shareholders' interest we should listen." On January 10, two

22. In 1965 or 1966, James Kelly of Combustion Engineering met with Basic representatives "trying to see if Basic would be interested in becoming a part of Combustion," as he recorded in a memorandum to file. Kelly agreed that it was correct to say that "an acquisition was not agreed to." Also, in 1975 Mr. Kelly raised with Max Muller "the possibility of joint venturing a seawater magnesite plant in Saudi Arabia." Nothing came of this inquiry.

days before Muller, Ludwig and Kelly met, Muller and Ludwig discussed a number of wide-ranging corporate topics with their general counsel, defendant H. Chapman Rose, who was also a Basic director. They discussed "Basic as a merger target," "present list of 'Suitors,'" ²³ "legal guidance [for Muller] on management's obligations and responsibilities."

Kelly's file memo of the January 12 meeting noted that he conveyed to Muller and Ludwig the sense of the C-E executive committee that C-E "is very interested in Basic, Inc. as an acquisition in order to be in a position to compete with H&W [Harbison-Walker], A. P. Green, General [General Refractories] and Kaiser."²⁴ He stated that "a presentation had been made to the Executive Committee . . . and the Committee had reviewed the facts presented and authorized continued negotiations looking toward acquisition." In exact words, the minutes of C-E's executive committee meeting of November 18, 1976 "authorized . . . as appropriate, negotiations with respect to the possible acquisition of Basic." As previously seen, this language limited "the proper officers" authority to "negotiations" and unlike the Executive Committee authority of December 14, 1978, did not authorize acquisition of Basic. Nor was any per share price mentioned. Moreover, Kelly's use of the term "continued negotiations," a term, which the evidence does not show that Muller adopted or approved, cannot bind Basic.

Plaintiffs state that "Combustion's management determined that the acquisition of Basic should be one of Combustion's

23. The list of "suitors" is embodied in the Muller memorandum entitled "Recent Interest in Basic." The list, as prepared on January 10, 1977, contains the names of eight companies that expressed interest in Basic and which at that time Basic had not rejected.

24. At the November 18, 1976 meeting of the C-E Executive Committee, Kelly "emphasized that . . . high investment costs would make it economically impossible to attempt to enter the basic refractories business through the construction of new facilities In addition, he noted that Basic seemed to be the only manufacturer of basic refractories which it might be feasible for the Company to acquire."

principal corporate initiatives, and that Combustion could pay up to \$30 million." Acquiring Basic, Inc. for \$30 million was one of several initiatives listed by Combustion's IPG for the period 1977-83. It was Kelly who decided to include this initiative in the 1976 Industrial Products Group strategic plan. However, on June 6, 1977 after reviewing that strategic plan, C-E's corporate staff withheld "approval pending clarification." At no time did either president Santry of C-E or the executive committee approve the \$30,000,000 figure proposed by Kelly in his IPG initiative.

In his January 12 1977 file memo, Kelly noted that Muller and Ludwig "were reluctant to arrange [a meeting with them or its board and Santry, CE's chief executive officer,] but [they] proposed instead that they talk informally with their outside directors and if a positive response was indicated, that the two of them would come to Stamford to meet with Mr. Santry and me." Kelly noted that he "agreed." However, no such Stamford (C-E home office) meeting ever took place.

The "Recent Interest in Basic" memorandum, distributed at the May 20, 1977 board meeting of Basic, was an update of the January 10 memorandum. C-E is shown as one of five companies which still expressed an interest in Basic, and which interest was not rejected by Basic. In the C-E block of information, it was noted that "Jim Kelly visited Cleveland at 9:30 Jan. 12 reaffirming CE's interest in Basic." Also, it was noted that "JK called MM on Feb. 17," that "JK called on May 10," and "MM may visit JK in July." That visit never occurred.

Asked about the "Recent Interest in Basic" memorandum distributed to directors at the May 20, 1977 board meeting, Muller thus reported its purpose:

To bring the directors up-to date on matters such as interest directly or indirectly displayed by other companies in our company. That was the sole purpose of the report.

Neither the agenda nor the minutes of the annual meeting of the board of directors of May 20 make reference to the

"Recent Interest in Basic" memorandum. Muller testified that he did not have any recollection or knowledge "as to why [his] report on recent expressions of interest in Basic is not included among the items on the agenda." Nevertheless, the distribution of the report at the May 20 meeting indicates that undoubtedly the reports' update was discussed by Muller.

Muller's memory crutch, dated June 27, 1977, reflects that on June 12, 1977, Roy Hegeman spoke (apparently by telephone) with Caito "on behalf of Jim Kelly." The conversation reported that a "tender offer may be made for Basic," mentioning "Steetley" (an English company). In a June 16 telephone conversation from Muller to Kelly, the latter told Muller that "Steetley people told him that they tried to acquire Basic" and "proposed to CE that CE join Steetley in acquiring Basic." He mentioned further that he had been told by a lawyer that his law firm (Sherman-Sterling of New York City) had been asked by an undisclosed company to assist in preparing "a tender offer for the shares of Basic."

In the June 16 telephone call, a June 24 meeting was discussed. Kelly's diary has an entry for June 24: "3 PM at Basic's office in Cleveland," but Kelly has no recollection of the meeting. Ludwig's diary shows a bracket between 3 p.m. and 4 p.m., "MM, AMC and Jim Kelly." Between 4 p.m. and 5 p.m. there is an entry: "Aftermath of above [with] MM and AMC." While Mr. Ludwig did not recall "what was discussed at either of the meetings," Ludwig stated that the "aftermath" was "whatever was discussed in the one that included Kelly." Muller did not recall the June 24 meeting. These diary entries permit the inference that Kelly met with Muller, Ludwig and Caito on June 24. However, no inference may be drawn as to the content of that meeting. Hence, nothing supports plaintiffs' argument in their brief, that they met to "discuss the possible merger with Combustion," or that following the Kelly meeting, "Muller, Ludwig and Caito met to further discuss the possible merger with Combustion."

Relying on a memorandum of board member Wilson of a phone conversation with Muller on June 28, 1977, plaintiffs

urge that Muller "told Wilson that he expected Combustion to make a 'merger offer for Basic'" Wilson described the memorandum as a "sketch list of notes on June 28 of '77." Under the heading "Combustion Engig," the memorandum stated:

ladle brick	Jim Kelley
alumina brick	VP 500,000,000

Wilson explained that he "didn't know anything about the company," that Max (Muller) "explained it," and he "put it down there."²⁵ Shown the exhibit, Muller explained that "ladle brick," and "alumina brick" are lines of products of CE's refractories division." The next three lines of the memorandum read:

friendly interest
merger offer for Basic
conflict interest

Muller did not recall discussing with Wilson "a merger offer for Basic" or "about a conflict of interest."²⁶ As for Combustion's "friendly interest," Muller stated: "Friendly interest . . . had been mentioned from time to time at the board."

25. Asked in his deposition about the memorandum Muller stated "Jim Kelly, V.P." is "obviously vice president," but he could not "find an explanation for the \$500,000,000." Contrary to plaintiffs' brief, he did not testify that "Combustion had some \$500,000,000 in annual sales." "Moody's Industrial Manual" reported the 1977 net sales at \$2 billion 44 million. A more likely explanation for the amount is Wilson's belief that Muller told him that CE "was a \$500,000,000 company." The 1978 "Moody's" reports CE's shares of common stock at 15,800,000 (after the 3-2 split). Given the quoted 1977 high/low of "41\$-33\$," the equity value of the company was about \$500,000,000.

26. Wilson was asked to tell what he was summarizing about his conversation with Mr. Muller when the memorandum says "Merger offer for Basic." Wilson reported that Max had said "that the interest of the contract was a friendly one because of understandably the two companies being in a similar business . . . but that there also quite likely might be an antitrust or conflict of interest problem if the discussions were carried any further."

This indicates that Muller had reported to the board Combustion's continuing "friendly interest" in Basic, communicated through Kelly. But it is not an admission by Muller that Combustion had made a merger offer or that Basic had entered into negotiations for a merger. Nor is Wilson's explanation of how he first became aware of Combustion's interest in Basic an admission of a Combustion offer. He explained he first became aware through

a routine telephone call from Max Muller who kept me advised on that and similar matters from month to month.²⁷

In all, Wilson's testimony, considered alone or together with the June 28, 1977 memorandum,²⁸ does not support the claim that on-going negotiations for a merger were taking place between Basic and Combustion in June of 1977. At most, his testimony considered together with his memorandum of June 27 shows that Kelly was displaying interest in Combustion acquiring Basic.

Plaintiffs state that on June 30, 1977, Rose, general counsel of Basic, "flew in specially to Cleveland, and Muller, Caito and

27. The lower half of the June 28, 1977 memorandum of Wilson further shows that Muller was reporting on all companies, not just Combustion Engineering, which had expressed an interest in Basic. It listed "U.S. Gypsum" and a "joint venture Fla.," and that "Cleve Gentlemen—buy substantial bloc Basic on market." "Chappie" Rose was noted as the source of the "U.S. Gypsum" and "Cleve Gentlemen" information.

28. Since Wilson's June 28, 1977 notes were not kept in the course of any regularly conducted business activity, they lack "the element of unusual reliability of business records . . . which produce habits of precision . . ." Advisory Committee Notes, Fed.R.Evid. 803(6). Therefore, they are not admissible as business records under that rule. However, his notes would be usable by him at trial to refresh his recollection. They would be admissible at trial under Rule 612 of the Federal Rules of Evidence only if the defendants called Wilson as a trial witness and the plaintiffs, as "adverse party," introduced any "portions which related to [his] testimony." Hence, standing alone, they may not be considered as admissible evidence that Combustion had made a "merger offer for Basic."

Rose held a meeting at the Burke Lakefront Airport to discuss Combustion's interest in acquiring Basic." In support, plaintiffs cite their Ex. No. 93, the June 30, 1977 entry in Ludwig's diary. The entry states:

To Burke

MM, AMC and HCR re CE and Conway

Quizzed about this entry, Ludwig makes no reference to Conway and agreed "that the subject of that meeting was Combustion Engineering." However, he had no recollection of what was said by anyone at the meeting. Rose's time sheets for June 30, 1977 show, "In Cleveland - Con. Messrs. Muller, Caito, and Ludwig Re Merger Offers." For July 1, 1977 his time sheets show, "Tel. Conferences Tucker, Steinbrink [Jones, Day lawyers], and Muller Re Conway and Combustion Engineering." These sheets seem to indicate that the "merger offers" entry of June 30 probably referred to both "Conway [a company interested in acquiring Basic] as well as Combustion Engineering." Rose had no "recollection, other than there was a meeting at some time at the Burke Airport." He stated that he was "generally in touch with the discussions that [Muller and Ludwig] were having with other companies." Concerning Combustion Engineering, he repeated earlier testimony that he "was aware that Mr. Kelly called on them from time to time."

Contemporaneously, under date of July 1, 1977, Ludwig forwarded to Rose financial comparisons of Basic and Combustion Engineering ("Balance Sheets, Income, and Relative Values, the latter current at 6/30/77"). In transmitting the materials, Ludwig noted:

Herewith the CE 1976 annual report and the analysis we usually make in considering mergers or acquisitions which I promised.

Ludwig denied that it could be assumed from his note, as assumed in the question of counsel for the plaintiffs, that the "financial sheets . . . were prepared by you because you were considering a merger between Basic and Combustion Engineering as of the dates on these documents were prepared."

Stressing the words "usually prepared," he said the language of his note did not mean that Basic was "considering a merger or acquisition." Plaintiffs refer to the "relative value" analyses for Basic and Combustion prepared in August 1976, June 30, 1977, March 1978, some time after September 30, 1978, and December 11, 1978 or soon thereafter. Ludwig testified that these "relative values" comparisons were prepared as "a routine matter . . . with respect to a variety of companies."

Asked if any of these reports were prepared in "connection with Combustion's expression of interest in acquiring Basic," Ludwig repeatedly answered that he had "no such recollection." Despite this lack of recollection, an inference that this was so would be permissible. However, an expression of interest on the part of Combustion in acquiring Basic is not tantamount to negotiations between the two companies. As seen in part I.B., merger negotiations about price, the principal term of the merger, were for the first time carried on by First Boston for Combustion and Kidder, Peabody for Basic between December 15, 1978 and December 19, 1978.

Plaintiffs argue that the "relative values" analyses "were all prepared to assist Basic in its ongoing merger negotiations with Combustion." However, there is no evidence that any of these reports were made available to Kidder, Peabody at least until mid-December 1978. Since Siegel learned for the first time of Combustion's interest in Basic on December 14, 1978, this means also that he was not given any of the C-E Basic relative analyses until after that date. Ludwig's handwritten notation, "do not give to Siegel," on the analysis which reads "current as of 12/11/78" makes this undisputed. Therefore, the record does not support plaintiffs' argument that "[t]hose analyses were all prepared to assist Basic in its ongoing merger negotiations with Combustion." Generally, with reference to these reports, Ludwig further testified that "Muller or Eells or any one of the senior management people could have requested the preparation of such a report on anybody."

On or about July 12, 1977, Kelly prepared several work sheets containing computations and estimates relating to Basic and Combustion Engineering. They were based in part on

published documents, e.g., Basic's annual report. Kelly testified that these were his notes "of how [he] thought a transaction [acquiring Basic] could be worked." A typed summary of Kelly's notes, dated July 12, 1977, indicates that it may have been circulated to president Santry and James F. Calvert of Combustion Engineering. Another typed page of Kelly's notes bears handwritten computations that related to premiums that Kelly "computed based upon a decline in the market price of CE stock range from 15 percent to 36 percent." These documents offer no proof that two-way merger negotiations were going on between Combustion Engineering and Basic. Six months later, a "review of industrial products group initiatives (in 1977)," dated January 9, 1978 from president Santry to Kelly, with carbon copies to J. F. Calvert and J. R. Rhode, make reference to the 1977 I.P.G. initiative to "*Acquire Basic, Inc.*" President Santry informed Kelly:

Approval withheld pending developments.

Because of Basic management's attitude, this does not appear to be an active area at present. Insure that corporate management is kept informed.²⁹

The next meeting between Kelly and Basic management representatives happened on October 12, 1977 when Kelly met in Cleveland with Muller, Ludwig and Caito. The plaintiffs contend:

Kelly, Muller, Ludwig and Caito specifically discussed the role that Basic would have in Combustion's corporate structure following Combustion's acquisition of Basic, and Kelly drew Muller, Ludwig and Caito a chart showing where Basic would fit in Combustion's corporate structure following its acquisition.

29. The January 9, 1978 "review" obviously refers to the so-called "strategic plan" for 1978-1984, dated September 23, 1977, in which the Industrial Products Group reaffirmed its commitment to acquire Basic for \$30 million.

The chart, undoubtedly roughly sketched during the meeting, as Kelly testified at the SEC hearing, shows a block at the top labeled I.P.G. A vertical line then runs down to a horizontal line below in which eight blocks are connected, one for each of the existing Combustion Engineering divisions in the I.P.G. To the left of the refractories division block, an added horizontal line extends to a block in which the word Basic is printed. While Kelly did not recall the meeting or the preparation of the chart, he thus described the chart:

The chart is, shows the organization of the Industrial Products Group as it existed at the time, and also shows where Basic would go if Basic were acquired by Combustion.

In his SEC testimony, Kelly asked if the chart was intended to show where Basic "would fit in upon its acquisition by Combustion." Kelly answered, "[i]f it were ever acquired." Further in his SEC testimony, Kelly thus characterized the chart:

An organizational chart that explains to the Basic people how they would fit into the organization. As I said before, they would be on the same level as the refractories and metals.

Muller's memory crutch describing the October 12 meeting states:

J. Kelly visits w. MJL, AMC, MM.
Talked in general about-
CE & Basic.

While there is no reference to the chart drawn by Kelly in Muller's memory crutch notes of the October 12 meeting, the notes are not inconsistent with Kelly's chart. As to whether any of the Basic people in the course of that meeting said anything "about future course of discussions," Muller in his deposition answered, "to the best of my recollection we said absolutely nothing. We were totally passive and left that up to Mr. Kelly." The undisputed evidence including reasonable inferences would permit a finding that Kelly indicated where Basic would

fit in the Industrial Products Group of Combustion if Basic "were ever acquired." However, there is no evidence that Basic indicated a desire to be acquired by C-E or that C-E would acquire Basic.³⁰

Relying on diaries and records of "Basic's and Combustion's personnel, and Basic's attorneys," plaintiffs contend that these "established numerous meetings, telephone communications, conferences and written communications relating to a possible merger between Basic and Combustion from September 1976 through October 21, 1977." One reference is the entry in Ludwig's diary for October 11, 1977. It states, "MM and AMC: prep. for 10/12 meeting." His diary for October 12 shows that he, Muller and Caito met with Jim Kelly from 9:00 a.m. to 10:30 a.m., and from 11:00 a.m. to at least 1:00 a.m., they met with "Duke Waddell, Jim ["Dick" in Muller's memory crutch] West, Bob Rubatsky," and under these names is "Flintkote." Ludwig's next entry reads, "MM AMC: RWG re Fredonia lime." Two meetings with outsiders occurred on October 12, and the Flintkote meeting particularly required preparation since it was known that Flintkote was going to be talking about a merger with Basic. Therefore, Ludwig's diary entries of October 11 and October 12 make it more likely that his entry on October 11 "prep for 10/12 meeting" referred to the Flintkote meeting rather than the meeting with Jim Kelly. Viewed most favorably for the plaintiffs, the entries permit equal inferences as to which of the October 12 meetings the October 11 "prep" made reference. Equal inferences are not probative facts.³¹

30. Plaintiffs argue that the jury could properly conclude that this was the subject of the meeting "based upon Muller's, Kelly's and Ludwig's persistent lapses of memory with respect to virtually all of their meetings, and the documents prepared by Kelly at the October 12 meeting." While lapses of memory would affect credibility of these witnesses at trial, these lapses cannot serve as independent evidence favoring the plaintiffs. See *Moore v. Chesapeake & Ohio Railway Co.*, 340 U.S. 573, 577-78 (1951).

31. Notably, counsel for plaintiffs made no inquiry of Mr. Ludwig in his deposition about the "prep" entry of October 11, 1977, which might have cleared up the ambiguity.

Other than on the dates of meetings with Basic management prior to October 21, 1977, which have already been discussed, Kelly, in this period of 1977, traveled to Cleveland on March 9, May 24, July 15, July 31-August 1, and September 7. He was unable to tell "which of the additional entries may have related to meetings concerning the possible acquisition of Basic." At the time there were two C-E plants in the Cleveland area, part of the industrial products group of Combustion, all under Kelly's jurisdiction. The record shows that he regularly traveled to Cleveland to visit these companies. Hence, no inference may be drawn that the "additional entries" on the specified dates related to meeting with Basic regarding Combustion's interest in possibly acquiring Basic.

Without attempting to discuss all the cited entries in the Jones, Day time records covering services rendered Basic by "seven lawyers" employed by Jones, Day in 1977, the entries noted for August and October (the month of the Basic public statement in the *Plain Dealer* on October 21) will be examined. The cited August 22 and 24, 1977 services of Harvey and Tavcar, or Harvey alone, relating to "proposed acquisition," are shown by an entry of August 23 as relating to the proposed acquisition of "Clay Company" (Cedar Heights Clay Company). Patently, it does not relate to Combustion Engineering. Harvey's time charge of October 18, "conference Ludwig and Tavcar re proposed acquisition and related tax matters," is explained by Ludwig's diary entry of October 18, "luncheon MJL HCH [H. C. Harvey] and TAT [Tavcar] re Reed and Cedar Hts." Ludwig's October 19 entry, "TAT re Cedar Heights Clay," adds further explanation. It is evident that Harvey conferred on October 18 with Ludwig and Tavcar regarding proposed acquisitions of H. B. Reed Company and Cedar Heights Clay. Again, Combustion Engineering was not the subject of time charges relating to such discussions. Plaintiffs quote "Harvey's diary" for October 20, 1977 as saying, "Phone conf. re tender offers (Ex. 226)." "Harvey's diary" (his time sheets) are contained in Ex. No. 225. The October 20 quoted entry of "phone conf. re tender offers" does not appear in his time sheets. The cited time entries for August and

October 1977, as seen, lend no support to the claim of plaintiffs that these records show that "Basic's attorneys were all devoting substantial time—and substantial expense—to the ongoing merger negotiations."

Mr. Ted Mayer, senior analyst with Hudson Research Reports, a service of Legg, Mason, Wood, Walker, Inc. (Legg, Mason), a stock brokerage firm, was based in New York City. Legg, Mason's principal office is in Baltimore, Maryland. On July 25, 1977, Mayer met with Mr. Alfred M. Waddell, senior vice president, finance, of the Flintkote Company. He informed Waddell:

Basic, [Inc.] is big in lime and lime products. I am of the opinion that the management of Basic, Inc. would be receptive to an exploratory meeting.

In September 1977, according to Muller's memory crutch, Ted Mayer informed him that "Duke Waddell of Flint[k]ote would like to talk merger." Muller called Waddell to set up the meeting on October 12. According to Muller's memory crutch, five days before, on October 7, Muller called Waddell and asked, "a) if Flintkote were buying up shares—b) if the \$25 tender offer rumor was true." The memory crutch states, "Waddell said *No* to both."

The memory crutch notes that on October 12, Waddell, West and Rabatsky visited Cleveland. They "talked about lime project in Kentucky." The note concluded:

It seemed clear that Waddell wanted to talk "merger," but we kept him on lime.

On October 18, 1977, Muller talked by telephone with Waddell. Among other things, the memory crutch records that "Flintkote does not think it worthwhile to consider the study on a Fredonia Lime project, *until* TVA becomes more definitive in their needs for lime." The memory crutch also quotes Waddell as saying there was no truth to the "rumor that Flintkote intends tender offer for Ideal Basic, Inc." Finally, the notes states, "Flintkote's interest is in Basic—will call again."

On October 20, 1977, Muller reported to Ludwig and Caito his telephone conversation with Duke Waddell on October 18, 1977. The middle item of the memorandum states:

B. Waddell had just received another rumor from Wall Street which stated that Flintkote is preparing a tender offer for Ideal Basic, Inc. (cement and mineral company). He said: Absolutely no truth to that rumor.³²

Muller's Flintkote memory crutch contains a page headed, "October 21, 77: Re Plain Dealer Article." Underneath that in Muller's handwriting appears:

MM called Waddell
read him the clip.
WAD approved;
asked for a c [copy] of clip. Sent immediately.

Underneath appears a xerox of the *Plain Dealer* story. In his deposition of November 24, 1981, Muller was asked, "Did that conversation [with Waddell, noted in the memory crutch] take place after the article had appeared in the *Plain Dealer*?" He answered, "No, prior to that." Whether Waddell approved the draft of the release before it was sent to the *Plain Dealer*, or the "clip" of the article after it was published, Muller's testimony on both February 4, 1981³³ and on November 24, 1981, and his

32. Item "A." of the memorandum concluded: "Waddell said that Flintkote would not be interested [lime project on our Fredonia deposit], not at least until TVA makes known their need for lime." Item "C" of the memorandum stated that "Waddell said Flintkote may be interested in a merger with Basic, so keep them in mind in case we need a friendly ally."

33. In his deposition of February 4, 1981, Muller testified that after the Flintkote visit of a "vice president of Flintkote and two mining engineers," Basic received numerous calls informing him of a rumor on Wall Street. In the first part of his answer he identified the "rampant" rumor "on Wall Street that Flintkote was about to make a tender offer for Basic shares at \$25." He testified that he telephoned Mr. Waddell at Flintkote "and asked him point blank if Flintkote indeed were suiting up, preparing a tender offer." He quoted Waddell as answering:

He said absolutely not, this was not true, and he said we'd better take steps to clear the air, whereupon I suggested that we prepare a release

Flintkote memory crutch, all show that "Waddell approved" what Muller and Basic stated in the *Plain Dealer* article of October 21, 1977.

Waddell's approval referred to the last sentence of the October 21, 1977 *Plain Dealer* article which stated:

[Muller] said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland-based maker of refractories for the steel industry.

Under the heading, "Basic, Inc. Stock Reaches New High in Heavy Trading," the article's first paragraph read:

Stock of Basic, Inc. reached a new high of 25 5/8 yesterday on volume of 29,000 shares, closing at 20. It was as low as 15 last month but has been heavily traded lately, including 40,000 shares October 7.

The article then continued:

President Max Muller said the company knew no reason for the stock's activity and that no negotiations were underway with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland-based maker of refractories for the steel industry.

In their amended complaint filed November 8, 1979, plaintiffs quote in full the second paragraph of the *Plain Dealer* article, quoted above and underlined the word "and" in the

to the *Plain Dealer* as quickly as we could and might also take it over to the Wall Street Journal.

Muller stated that he read the statement (prepared by himself, Ludwig, Thomas, and perhaps Collins, director of public relations) to Waddell. He stated he did not recall "whether [Waddell] suggested editorial changes which were in fact incorporated or not, but suffice it to say that he approved the form in which the release was taken over to the *Plain Dealer*."

first sentence. In paragraph 24, referring to that first sentence, plaintiffs allege:

Defendants' statement that "no negotiations were underway with any company for a merger" was false and misleading in that, as averred in paragraph 20(a) hereof, defendants knew that Basic was actively engaged in a continuing negotiation with Combustion with respect to an acquisition of Basic by Combustion.

Elaborating that claim, plaintiffs further allege that "[d]efendants knew that the investment community and Basic's shareholders believed or had reason to believe that merger negotiations with some company were in progress." They allege that "[d]efendants knew that the holders of Basic securities would rely upon their explicit disclaimer of pending negotiations in making their investment decisions . . . and that the disclosure of the existence of such negotiations would have resulted in an increase in the market price of Basic's securities." Concluding the paragraph, plaintiffs assert:

Accordingly, defendants had a duty as of the date of that public statement to disclose the existence of the continuing negotiation with Combustion in order to make their flat disclaimer of the existence of any such negotiation not misleading.

Plaintiffs claim that "[d]efendants' statement that 'no negotiations were underway with any company for a merger' [the first sentence of paragraph 2 of the *Plain Dealer* story] was false," will first be considered. The denial of merger negotiations in the first sentence with "any company," in the eyes of a reader, would primarily be linked with the denial in the second sentence of Wall Street rumors of a Flintkote "tender offer of \$25 a share for control of the Cleveland-based maker of refractories for the steel industries." Both Flintkote's and Basic's denial of that Wall Street rumor is undisputed in the record. Thus, the plaintiffs' claims of falsity, as made clearer by the allegations of paragraph 24, actually center on the claim

that the no-merger negotiations statement was false because "defendants knew that Basic was actively engaged in a continuing negotiation with Combustion with respect to an acquisition of Basic by Combustion."

The review of corporate events prior to the October 21, 1977 *Plain Dealer* article, and the findings which this court has made concerning those events, make two things clear. Kelly on different occasions, and as late as October 12, 1977, had contact with Basic. In these meetings he did indicate Combustion's interest in acquiring Basic. However, president Arthur J. Santry of Combustion Engineering testified that

you know, Mr. Kelly cannot decide to acquire Basic.

He might decide to recommend it to me, but that is all he could do. I mean nothing could happen unless I o.k.'d it.

Thus, it is undisputed that as of October 21, 1977, and in fact at no time, did Combustion ever authorize Kelly to do more than recommend to his superiors an acquisition of Basic by Combustion, or a merger of the two companies. As seen, to constitute negotiation in the applicable legal sense means "to bring about [an agreement] by mutual arrangement, discussion, or bargaining." C.J.S., *supra* at 17. The evidence is undisputed that at no time did Muller, Ludwig or Caito engage in any bargaining with Kelly, tantamount to merger negotiations. Such negotiations occurred for the first time in the time slot of December 15 through December 19, 1978.

The alleged falsity of the October no-merger negotiations statement must be tested by the truth of plaintiffs' assertions that Basic was conducting ongoing negotiations with Combustion Engineering. There is no evidence that would permit such a finding. The record shows not only that there is a lack of a genuine issue of material fact as to plaintiffs' claim that Basic was engaged in ongoing merger negotiations with Combustion Engineering, but also there is a lack of a genuine issue of material fact as to plaintiffs' claim that Basic was carrying on merger negotiations with any other company.

In this state of the record, the court determines as a matter of law that plaintiffs' claim that "defendants' statement that 'no negotiations were underway with any company for a merger' was false" is not supported by evidence in the record which presents a genuine issue of material fact. On the present record it is concluded that Basic's statement that "no merger negotiations were underway with any company" was true.³⁴

Plaintiffs charged that this statement was "misleading in that [as previously quoted] . . . defendants knew that Basic was actively engaged in a continuing negotiation with Combustion with respect to an acquisition of Basic by Combustion." As seen, plaintiffs further allege that "[d]efendants knew that the investment community and Basic shareholders believed or had reason to believe that merger negotiations with some company were in progress."

Thomas, Basic's secretary-treasurer, testified that he "never heard a rumor about Combustion." But he agreed that he had heard "rumors, generalized rumors, about a possible merger involving Basic." As to the source of these merger rumors, he said he heard about the rumors by telephone from brokers and stockholders. Asked to qualify them, he said in "one particular day, it could be one to ten, 15." He received these calls in months of "high [trading] activity," March, May, September and October 1977. Asked to identify specific companies that were identified by brokers and stockholders during 1977 and 1978 "as being involved in merger rumors relating to Basic," he first named Flintkote. But he said "most of them were uniden-

34. At the board of directors meeting on November 18, 1977, Muller "discussed recent market prices," "volume of trading of the Corporation's stock," and "various rumors." His further statement to the board that "no approach has been made," conforms to his public statement that "no negotiations were under way with any company for a merger." Further confirming the truthfulness of his public statement is his explanation of the October 1977 trading activity. In his letter of December 8, 1977 to Mr. H. P. Eells, Jr., he pointed out that "a total of 300,000 shares changed hands during the month of October, whereas the normal monthly volume had been on the order of 50,000 shares. He then stated, "as I explained to you earlier, we suspected that someone was trying to purchase control of our company."

tified . . . Swiss companies, generally, Belgian companies, English companies, domestic companies." He thought that Hanna Mining Company was one company that was mentioned. Other names, learned not by telephone but from sources he could not identify, were TRW and Diamond Shamrock.

Plaintiffs note that "Thomas was deliberately kept uninformed about Basic's ongoing negotiations with Combustion throughout 1977 and throughout much of 1978 . . . [yet] the telephone calls from brokers and shareholders asking about the truthfulness of rumors about merger discussions were routed to Thomas, and Thomas was given the responsibility to respond to those inquiries." This court has found that there were no "ongoing negotiations with Combustion throughout 1977." It is correct that Muller deliberately limited access to knowledge of approaches by Kelly of Combustion, as well as his expressions of Combustion's interest in acquiring Basic, to Ludwig and Caito of Basic management, and general counsel Rose. Knowledge of Kelly's approaches to Basic management, but not all the details, were shared with members of the board of directors. Because these approaches of Combustion's Kelly had not reached the negotiating stage, and an agreement in principle to merge Combustion and Basic was not imminent, Basic management had no duty to inform Thomas, as the person designated to answer telephone calls about Basic's stock trading activity, about Kelly's approaches to Basic management. A duty of management to inform Thomas of those approaches would have arisen if those approaches had leaked to the street and he was required to admit or deny Combustion "interest" rumors. Indeed, Basic would then have been required to issue a public statement acknowledging Combustion's "interest." Since there were no street rumors about Combustion's "interest" in Basic, and since Thomas made it clear that he "never heard a rumor about Combustion," his general denials of rumors of "take-over" of Basic were not inaccurate.

Apart from the evidence of Wall Street reports of rumored merger activity, the record contains no evidence to support

plaintiffs' claim of merger negotiations with Flintkote or with any other company. Thomas's responses to stockbrokers or stockholders, which denied merger rumors, complied with the requirement in the *New York Stock Exchange - Company Manual* that "[i]f rumors are in fact false or inaccurate, they should be promptly denied or clarified." Moreover, only if "the state of negotiations or the state of development of corporate plans in the rumored area" accounted for the unusual market activity did the Manual require Basic to make "an immediate candid statement to the public" as to those matters. *Id.* at A-23. The evidence considered most favorably for the plaintiff does not show that the Combustion approaches to Basic accounted for the unusual market activity of Basic's stock.³⁵

Rule 10b-5 makes it unlawful to "omit to state a material fact necessary to make the statements made in the light of the circumstances under which they were made, not misleading." In effect, plaintiffs argue that even if "no merger negotiations were underway" between Basic and C-E, the October 21 statement was misleading because it failed to disclose that Basic had been approached by and was meeting with CE. As plaintiffs state, "[i]f material facts are omitted, defendants may be held liable for their misleading public statements even if those statements, literally, were true."

Plaintiffs say the issue is whether Basic omitted to state facts "that a reasonable investor would consider important." Plaintiffs further state:

35. In support of their respective positions, each side has quoted and referred to the text of *New York Stock Exchange - Company Manual*, "Dealing with Rumors of Unusual Market Activity," A-23 (plaintiffs' Ex. No. 66 of the record). The court has considered this provision of the Manual as evidence bearing on the nature and extent of public release of information required under Rule 10b-5. The question does not arise as to whether this portion of the Manual would create a basis for an implied private right of action against Basic as a member of the New York Stock Exchange. Only "fairly specific rules" have been held to provide a basis for a private right of action against a member of the Exchange. See *Van Alen v. Dominick & Dominick, Inc.*, 560 F.2d 547, 552 (1977).

In order to sustain their burden on these motions, defendants must . . . demonstrate "conclusively," and as a matter of law, that none of the discussions between Basic and Combustion were material at the time of the October 21, 1977 . . . statement.

However, as held in *Staffin, supra*, at 1206, "preliminary merger discussions are immaterial as a matter of law because disclosure of them may itself be misleading." Given their broadest reading, the corporate events occurring before October 21, 1977, which have been reviewed, do not fall within the category of "preliminary merger discussions." In any event, these corporate events were clearly immaterial. Basic was not misleading the public by not disclosing that several companies had expressed an interest in acquiring it. To borrow language from *Staffin*, public disclosure of these expressions of interest, including that of Combustion Engineering in acquiring Basic, "may itself [have been] misleading." Basic acted reasonably and with good business judgment in not adding to an atmosphere already full of merger rumors at a time when the possibility of a merger with Combustion Engineering, or any other company, was speculative at best. The corporate events chronicled in part I.B. demonstrate that merger negotiations between the two companies occurred for the first time from December 15 through December 19, 1978.

Examining the factual record in the light most favorable to plaintiffs, it is determined that no genuine issue of material fact exists as to the truth of Basic's October 21, 1977 public statement. It was true as a matter of law. Furthermore, no genuine issue of material fact exists as to the misleading nature of the statement, viewed "in the light of the circumstances under which [it was] made." As a matter of law, the statement was not misleading.

B.

Relevant corporate events occurring between October 21, 1977 and September 25, 1978 when the second public statement was issued, will now be recounted.

According to the first letter of agreement between Kidder, Peabody and Basic, Inc., the six-month retainer was effective on November 16, 1977. Preliminarily, Ludwig and other Basic representatives met vice president Martin Segal and other Kidder, Peabody representatives at Kidder, Peabody's New York office on November 9, 1977. Kidder, Peabody's notes of that meeting show:

Ted Thomas, secretary and treasurer; Mat Ludwig, Vice V.P. Finance, and their lawyer visit K-P and talk with Doug Brown, Joe and Martin Segal.

Talked about tender offer. Suggested they retain us for \$20,000 for six months.

In light of an earlier meeting on October 18, 1977 between Kidder, Peabody representatives and Ludwig, the talk "about tender offer" in the November 9 notes relates to a "tender offer defense."³⁶ Muller's letter of December 8, 1977 to H. P. Eells, Jr. explained Kidder, Peabody's function. He wrote:

In order to be prepared against an unwanted and hostile takeover, we have employed specialists who are experienced in the defense against such raids. We have scheduled a meeting here with these specialists to be held December 14, 2:30 to 5:00 p.m., to assess the current situation and also to obtain their views on countermeasures to be taken in case such an offer is received. We are

36. Pointing to a meeting on October 18, 1977 between Kidder, Peabody representatives and Ludwig, plaintiffs argue that "Basic approached Kidder, Peabody to discuss the possible employment of Kidder, Peabody as Basic's investment advisor to prepare evaluation of Basic for use in merger negotiations with Combustion." Kidder, Peabody's notes of the October 18 meeting show that such was not the subject of the October 18 meeting:

JFC/GSP [Jeffrey S. Parker] and Fred Rothacker (KP-Cleveland) visited with Mat Ludwig, VP-Fin. Didn't talk ratios due to lack of interest. Company feels some sense of loyalty to First Boston, but opportunity to replace them is real. *Discussed tender offer defense and Mat would like to meet with Marty Segal, perhaps in November.* We should also include John Crosby. Mat Ludwig is an avid golfer. [Emphasis added.]

inviting, on an informal basis, members of our Board to attend and I hope that you will be able to join us at that time.

The meeting on December 14, 1977 at Basic was attended by vice president Siegel, Lowry and Parker of Kidder, Peabody, Muller, Ludwig, Caito and Thomas of Basic, Steinbrink and one other Jones, Day attorney.³⁷

Kidder, Peabody's second function as Basic's investment advisor was "to evaluate Basic." According to Muller, Kidder, Peabody did not render its opinion on the value of Basic stock "to [him] and/or Mr. Ludwig [until] about Saturday or just about one day or a day and a half before Mr. Santry came to visit us in Cleveland." Vice president Martin Siegel testified substantially the same, as indicated in part I.B, *supra*.

The first conversation between Kelly and Muller after the October 21 *Plain Dealer* article shows no indication of the "ongoing merger negotiations" between Combustion and Basic which plaintiffs attributed to the October 12 meeting of Kelly and Basic management. Thus, Muller's memory crutch shows that on October 27, Kelly called Muller and passed on to him the rumor "that Hepworth Ceramics, Ltd.] of England may be interested in Basic." On November 10 Muller informed Kelly by telephone "of Morgan Stanl[e]y's part in Hepworth." The memory crutch then records:

Kelly asked: Are you ready to merge in Basic?

MM said not yet.

37. Steinbrink's time sheets regarding Basic, Inc. indicate "Re: takeover defense" October 27, 1977, November 1, 1977, November 4, 1977, and November 9, 1977. The last entry adds, "Review of draft set of papers" with "Ludwig, Thomas, Siegel and others." Likewise his time sheets for November 15, 1977 and December 11 through December 14, 1977, culminating with a conference on the latter date at Basic with Muller, Ludwig, Segal and others, again relate to "Re: takeover defense." The nature of Steinbrink's services further refutes the plaintiffs' contention that Basic's relationship with Jones, Day between 1976 and October 1977 indicates the merger with CE was being vigorously pursued by Basic.

Muller's interpretation of Kelly's question as being "more in jest" would imply that his answer of "Not yet" was also "in jest." But should the trier of fact decide that Kelly or Muller each spoke in earnest, what would be the significance, if any, of Muller's answer—"Not yet?" At most, it would mean that Muller was not now accepting a merger proposal but that perhaps somewhere down the line a merger proposal might be accepted. So viewed, such statement amounted to a "preliminary merger discussion," nothing more.

While there is no basis in the record for plaintiffs attributing to Muller the feeling that "further preparations for a merger with Combustion were required," there is basis for plaintiffs saying that "an evaluation of Basic . . . had previously been requested" from Kidder, Peabody. In his first deposition, Muller testified that the "most compelling reason to obtain an independent evaluation of Basic" was that

we were desirous to purchase the refractories division of CE, and the possibility existed or even perhaps the necessity existed that the compensation for that division would have to be at least partially in Basic shares. Therefore, we wanted to have an independent appraisal of the true value of our shares.

As the other reason for "an independent evaluation of Basic," Muller stated:

[I]f we received or were surprised by an unanticipated tender offer, that we were on solid grounds to communicate to our shareholders and advise them what steps to take based on what we called competent evaluation of our stock.

In his deposition, resumed five months after the foregoing testimony, Muller was asked what harm would be suffered "if Basic had received a formal offer of Combustion Engineering's best figure prior to the completion of the Kidder, Peabody evaluation." Answering in the context of "any offer," he then repeated the substance of the previously expressed second reason for an independent evaluation of Basic stock:

Any offer would call for a speedy response and reaction. Without having in hand some expert opinion on the assessed value, assessed by financial experts, of our shares, an intelligent and speedy response would not be an intelligent one, or not an authoritative one, and would have to be evasive, delaying.

This is the possible danger that I saw in an offer forthcoming prior to having in hand a solid document, a solid appraisal by a reliable firm.

Neither this testimony nor any other evidence in the record supports plaintiffs' claim that "following the October 27 conversation [a Kelly call to Muller] Basic began meetings with K-P to assist K-P in beginning work on the appraisal of Basic to assist in Basic's further negotiations with Combustion for a merger." Rather, this evidence only shows that Basic sought an independent evaluation of its stock by Kidder, Peabody so that it would be ready for "any offer" that might be made by any company. As seen, Kidder, Peabody was not informed of the interest of Combustion Engineering in acquiring Basic until December 14, 1978. While at that time Martin Siegel indicated that Kidder, Peabody had worked on "previous analysis of the company," he "suggested that we would completely update ourselves on our analysis of the company to make sure we were fully up to date."

Muller and Ludwig met with Kelly on February 27, 1978 at Cleveland's Burke Lakefront Airport. The meeting had been arranged by a telephone call from Muller to Kelly on February 6.³⁸

38. In that conversation, Muller informed Kelly of "an impending visit by Peter Goodall and Derik Booth [of Hepworth]." This was a follow up of Kelly's October 27 report to Muller of the Hepworth rumor and Muller's November 10 call to Kelly to report to Kelly "Morgan Stanley's part in Hepworth." This exchange of information regarding Hepworth is consistent with Muller's SEC testimony (showing Combustion's interest in merging with Basic):

[T]he conversations were extremely low-keyed, and to my knowledge he stated twice: "I don't want to read in the paper that Basic has merged, or been sold, or accepted a tender offer."

Muller's memory crutch indicates that the Burke Airport meeting with Kelly was "Refr[actories] meeting." The testimonies of Ludwig, Muller and Kelly indicate that Muller and Ludwig raised the possibility of Basic acquiring C-E's refractories division. Ludwig stated:

I think he was a little surprised, but he nonetheless agreed to provide us with the information which would permit us to make a judgment on whether we felt it was something that did fit our situation and that not only product-wise, but dollar-wise.

Muller indicated an interest not only in C-E's refractories division but also in their minerals division. However, Kelly said "to leave the mineral divisions out of consideration." As to the refractories division, Kelly indicated that he would recommend "whatever method of payment would seem advantageous, fair and feasible, and that included the suggestion that part of the price would be cash and Basic stock."

As a result of the February 27 meeting, Combustion provided financial data to Basic, and Basic provided financial data to Combustion. Combustion's financial data related to its refractories division. It was Ludwig's recollection that Basic's financial data were the "actual numbers" for the years 1973 through 1976; 1977 were estimated numbers, and 1978 were "budget numbers." Basic also gave Combustion "what amounts to cash flow, as to what capital improvements [Basic] contemplated, debt requirement for servicing the then senior securities, that sort of thing." Asked why it was his belief that "Basic would have to make a deferred payment for Combustion's refractories division," he answered, "[b]ecause we didn't have the resources otherwise."

At the March 22, 1978 meeting in Cleveland in which financial information was exchanged, Preston Insley, vice president and group controller of IPG of C-E, Matt J. Ludwig, vice president in charge of finance of Basic, and E. P. Arnholt, Basic's controller, were present. Arnholt had prepared an operating profit statement separately for each Basic segment, electronics, chemicals, and refractories, for the years 1973-

1977. Budgeted figures for 1978 were written on a separate column on each of the statements. Following the March 22 meeting, Insley received additional information. From the financial data supplied by Basic, Insley prepared a consolidated profit and loss statement which appears as one of the financials which comprise plaintiffs' Ex. No. 106. This consolidated statement projects Basic's 1978 net income after interest as \$4,386,000. This set of financials (plaintiffs' Ex. No. 106) was prepared for the meeting scheduled for June 7 of Kelly and Basic management. The financials also included comparative income statements, "CER [Combustion Engineering Refractories] vs. Ref [Refractories] Division of Basic; CER vs. Basic Inc., Consolidated, and Basic, Inc. Consolidated vs. CER," and a statement entitled "Analysis of Average Assets Employed" which relates to Basic's three segments and Basic, Inc. Consolidated.

In their brief, counsel for plaintiffs assert:

In his testimony before the SEC, Muller was asked why Basic gave Insley the confidential earnings projections for Basic at the March 22, 1978 meeting.

They then assert:

Muller testified that he gave Insley the earnings forecast to assist Combustion in comparing an offer for Basic, *not* in connection with any plan by Basic to acquire Combustion's refractories division. . . .

To support these assertions, counsel for plaintiffs quote the following SEC testimony of Muller:

Q. Why did you give that figure to Mr. Kelly?

A. Combustion Engineering seemed serious about preparing an informal offer; and in the interest of the company, they should have a reasonable estimate of what 1978 would [look] like for them to prepare an intelligent offer.

Q. You gave them this forecast to assist them in preparing this offer?

A. Yes.

It is immediately apparent that the question related to Kelly, not Insley, for Muller was asked why he gave that figure, "something close to 5 1/2 million,"³⁹ to Kelly. Later, on July 13, 1978, prior to Kelly meeting with First Boston, as will be discussed, *infra*, Muller provided an updated Basic 1978 earnings projection. There is no evidence in the record that shows that Basic intentionally provided Insley with the financial data of Basic "to assist Combustion in preparing an offer for Basic."

This is not to say that Kelly was not interested in obtaining the Basic financial data to assist him in pursuing his "strategic plan" to acquire Basic. Insley thus described Kelly's stated purpose in exchanging financial data with Basic:

The understanding, as I believe I said earlier, was that we could—we may be interested in acquiring Basic. We may be interested in selling our refractories division to Basic. Both of those things were discussed with Mr. Kelly as an ultimate possibility. [Both before and after the March 22 meeting.]⁴⁰

Plaintiffs argue that in examining all of Basic's operations and divisions, Insley was "specifically examining the consequences of an acquisition of Basic by Combustion." Plaintiffs cite handwritten notes of Insley in which he "examined Combustion's return on investment ("ROI") in the event that it

39. In his answer he also stated: "The Insley March forecast predicted earnings of 4.5 million. Excuse me, 4.6; and [he] suggested to Kelly that he could use something close to 5 1/2 million."

40. With reference to the exchange of information, Insley answered "no" to the question whether Basic representatives said anything to him "which indicated what their understanding was as to the possible use of the [exchanged] information." However, he did say that he believed Ludwig used the term "we might get together." Obviously, this could have applied to Basic acquiring CE's refractories division. It could also have applied to CE acquiring Basic. But even if the latter meaning is attributed to the remark, it does not indicate that a merger was likely to occur or that negotiations to merge were in progress.

paid \$36,400,000 to \$38,000,000 for Basic and his analysis of "the cost of acquiring Basic at a price of \$36-\$37 per share, or \$36,000,000," a substantial premium over the existing market price of Basic stock. Insley did not recall "preparing anything specifically for that [June 7] meeting." But yet it may be assumed that his calculations were prepared for that meeting. When asked "Were you doing this to be prepared to advise Mr. Kelly in the event that he asked about the feasibility of making an offer," he answered, "I would say yes."⁴¹

Plaintiffs further contend that to prepare for the June 7, 1978 meeting with Kelly, "Basic's management also prepared analyses to determine what would be a fair price for Combustion to pay to acquire Basic." To support this contention, plaintiffs rely on handwritten entries on the second sheet of Ex. No. 90 and testimony of Ludwig.

The three sets of figures on sheet two of Ex. No. 90 comprise one set in the handwriting of Thomas and the second and third sets of figures in the handwriting of Ludwig. Thomas's figures appear to list the stock earnings and stock prices relating to Vetco CE, a company which was acquired by C-E, probably late in 1977.⁴² Thomas's bottom line reads "Tender offer-\$23."

41. In subsequent testimony, Insley was asked about his handwritten calculations on page 11 of plaintiffs' Ex. No. 44 (the first four pages were provided to him by controller Arnholt of Basic on March 22), and which calculations arrive at "price/36-37" and under that "36 million." He testified he did not recall whether he made these calculations before or after June 7, and he did not recall "whether I did it on my own or whether I was asked." But he agreed that either he or Kelly decided to do the calculations. It is concluded that the trier of fact reasonably might find that Insley's handwritten calculations were made before the June 7 meeting and probably were shared with Kelly. However, there is no evidence in the record that the calculations were shared with anyone at Basic.

42. According to Ludwig, the figures, in Thomas's handwriting, showed "market values of earnings per share of an entirely different company," that is, Vetco-CE. As to the stock prices for the indicated years 1975 through the first quarter of 1977, he said that "[t]hey do not appear to be prices of Basic stock." Similarly, under the heading "Earnings Per Share (Fiscal 3/31)," appear figures for each of the same three years.

The middle and lower sets of numbers on the second sheet are in Ludwig's handwriting. The middle set lists forth stock earnings and stock price ranges for "NG [National Gypsum]" and "U.S. [United States Gypsum]." Ludwig indicated that one of these two companies, he wasn't sure which one, had expressed an interest in acquiring Basic. In the set of figures at the bottom of the second sheet are calculations in Ludwig's handwriting, the purpose of which he was unable to explain. The middle column contains the entry "\$6,900,000 sh[ares] at 23." As seen, this is the indicated tender offer price of Vetco-CE. When Ludwig was asked "why Mr. Thomas would have prepared a document reflecting figures for Vetco," he answered, "I don't think I have any recollection of why, but then—." Given a chance to complete his answer, he said "No. I just said I don't have any recollection of why he did or may have."

While the sheet is undated, the inclusions of only first quarter figures of 1978 for National Gypsum and United States Gypsum by Ludwig indicate that the entire sheet may have been prepared during the second quarter of 1978. Thus it may have been prepared prior to June 7, the date of the meeting of Basic management and Kelly. Thomas's inclusion of stock prices and earnings per share, presumably of Vetco-CE, the tender offer of \$23 a share, and Ludwig's calculation at the bottom of the second sheet relating in part to the tender offer price indicates a definite interest on the part of Basic in C-E's acquisition of Vetco. However, this data is not sufficiently complete to justify the statement of plaintiffs that

Ludwig and Thomas prepared an analysis of another company which Combustion had acquired in November 1977, Vetco, the earnings of that company, and the price which Combustion had paid to acquire the company, to determine the price which Combustion should be expected to pay for Basic.⁴³

43. Counsel for plaintiffs also assert that "Ludwig also analysed the effect that Combustion's accounting policies would have on Basic's reserves

Seeking to prove that "Muller and Ludwig knew that Combustion would be making a formal offer to acquire Basic" on June 7, plaintiffs quote director Wilson's notes of a telephone conversation with Muller on April 4, 1978. The relevant portion of the note is here duplicated:

4/4 ph Max Refractory
Combustion Div
Eugene VP
Jim Keller Pres. - div.
2 weeks ago
exploratory proceeding
MAX THINKS MAYBE
25-30 = /sh

For the reasons explicated in n.28, *supra* at 42, Wilson's telephone conversation notes are not independently admissible. Without resorting to his notes, he testified in his deposition:

That phone conversation was about Basic's interest or explorations then ongoing perhaps or then ongoing in the

following an acquisition by Combustion and the application of Combustion's accounting policies to Basic." This is a reasonable inference to be drawn from the first sheet of Ex. No. 90 in which Ludwig agreed he had taken "the percentage of [LIFO (Last In First Out)] reserves that Combustion used" and "applied that percentage figure to Basic's inventories," further, that he went through "calculating the effect of using Combustion's percentage of LIFO reserves ultimately upon Basic's earnings per share." This is true even though he said he did not know the end purpose of this exercise. Both sheets of Ex. No. 90 and Ex. No. 90A, "Additions to LIFO Reserve," cannot be classified as having been prepared as "a routine matter . . . with respect to a variety of companies, an explanation given by Ludwig to other "relative values" analyses."

possibility of acquiring the refractories division of Combustion for cash as I remember.

However, Wilson also testified that he did not "know what the \$25 to \$30 figure meant. I can't recollect what that meant when I wrote it down."⁴⁴

Plaintiffs further allege that on April 11, 1978 and May 26, 1978, Muller "reported to Basic's Board of Directors on the status of Basic's ongoing discussions with Combustion." This is true. In his testimony, Muller explained that he

informed the Board of our desire to acquire the Combustion Engineering refractories division and assumed tacit approval, since there seemed to be agreement among the Board members that this would be a wise step.

It is undisputed in the record that Muller took up with the board Basic's interest in acquiring C-E's refractories division. Hence, the previously quoted entry from the board minutes most reasonably means that "Basic's ongoing discussions with Combustion" concerned Basic's attempt to acquire C-E's refractories division. However, if the "ongoing discussions with Combustion" included discussion of C-E's interest in acquiring Basic, this may not be equated with "ongoing negotiations" to acquire Basic.

C-E's Kelly visited Basic management June 7, 1978 as scheduled. Muller's memory crutch entry of June 7 corroborates that Basic's offer to purchase C-E's refractories division actually was then pursued by Basic but rejected by Kelly. But it also shows that Kelly's expression of interest in Basic became bolder. The memory crutch states:

JK visits us in Cleveland - meet w[ith] MJL AMC MM

(a) we suggest purchase of CE ref. for 11.7% [of authorized shares] i.e. \$26,000,000. Kelly says "too low"

44. Wilson's affidavit shows that on April 4, 1978, the day of the telephone call, "he sold 944 shares of Basic's common stock . . . in an open market transaction at a price of \$20 per share." Had he thought that Combustion was about to make an offer of \$25 to \$30 a share, surely Wilson would not on the same day have sold 944 shares of Basic at \$20 a share.

(b) Kelly indicate[s] \$28/sh, stock we say "too low"

(c) Kelly suggests _____ for CE to give us their best figure. MM says: Hold off til we "tell you"

In his memo to file (not "memo to Santry," as plaintiffs assert), Kelly records that he met in Cleveland's Basic office with Muller, Caito and Ludwig "to discuss the possible consolidation of our refractories division." This states the primary purpose of the June 7 meeting. This purpose is corroborated in the second paragraph which begins, "We reviewed the consolidation financial prepared by Preston Insley." He apparently is referring particularly to the comparative income statements prepared by Insley (part of plaintiffs' Ex. No. 106).

In his SEC testimony, Kelly stated that the purpose of the meeting was "[t]o review the financials of the combined companies." In his deposition testimony he stated that plaintiffs' Ex. No. 45 ("Basic, Inc. - Assumptions and Information") was "part of the package of financials that Mr. Insley prepared," and he believed that he "delivered a package of financials to Basic." Also, he believed that the package included "the put together data of the two refractory companies." The second sentence of paragraph 2 of Kelly's memo to file states:

After review [Insley consolidated financial], Max suggested that Basic buy our Refractories Division for book value. I said that we might consider this for stock of Basic, but not for cash.

Nothing in either the Insley financials, the testimony of Kelly, or his file memo supports plaintiffs' assertion that Basic management met with Kelly on June 7 "to review the analysis and financial statements prepared by Insley studying the acquisition of Basic by Combustion."

As Insley indicated, in his discussion with Kelly the alternative to "selling our Refractories Division to Basic" was that Combustion "may be interested in acquiring Basic." It may be inferred that the Insley financials relating to Basic, Inc. underpinned Kelly's suggestion to Basic management "that we con-

solidate by C-E buying Basic." He said that he "thought that \$28/share in cash, or CE stock would be a price I could recommend to Mr. Santry." It is important to note that Kelly did not make an offer but rather said that he would recommend the "\$28/share in cash, or CE stock . . . to Mr. Santry." As previously discussed, Kelly had no authority to make a formal offer, on behalf of C-E. Muller's memory crutch recording Kelly's indication of \$28 per common share is consistent with Kelly's designating the figure as a figure he "could recommend to Mr. Santry."⁴⁵

The reaction of Basic management was immediate. Kelly's file memo records:

They then pointed out that if they were to consider a sale, a price as low as \$28 would be out of the question.

Similarly, in his memory crutch, Muller recorded: "Kelly indicates \$28/sh - We say 'too low.'"

The balance of the conversation is thus recorded by Kelly:

After additional discussion, I posed the question of whether they would be receptive to considering an offer from CE at some higher price. The[y] agreed to call me the week after next with a response. If the answer is positive, then I will consult with Mr. Santry on whether he wishes to make an offer and if so, at what price. The four of us, plus Ed Arnholt and Bob Gates had lunch at Hermit Club.

No such response, positive or otherwise, was received by Kelly.

The result of the June 7 meeting was "iffy" on both sides. Basic's management said *if* a sale were considered, the \$28 price was "too low." Kelly made it clear that even if Basic

45. With reference to the June 7 meeting, Muller wrote in his diary:

Office 9:00 o'clock. Jim Kelly of CE offered \$28. Hermit.

Confronted with this entry, Muller explained:

It's my testimony that this was a feeler, that he expressed it as such, what would you think to such a figure, and with my shorthand I put down offer, which is totally wrong.

responded in two weeks that they wanted C-E to make an offer, it would be essential for him to "consult with Mr. Santry on whether he wishes to make an offer and if so, at what price."⁴⁶

Following the June 7, 1978 meeting, Muller, Ludwig and Caito met with Rose at Jones, Day's office in Cleveland on June 16, 1978.⁴⁷ Muller's memory crutch recorded:

6-16-78

Cled [Cleveland], HCR's office. MJL AMC MM HCR

Discussed results of "Kelly" meeting

(6-7-78) - Outlined plan

- a) Bring Kidder-Peabody in on an evaluation
 - b) Have Steinhaus look at CE v/s Basic & USG [U.S. Gypsum] v/s Basic
 - c) Ask CE for their "best" offer, informally
 - d) Up date Raid-defense Steinbrink Kidder-Peabody
- [emphasis in original]

46. From Kelly's standpoint, the inconclusive nature of the June 7 discussions was reflected in Insley's testimony. He stated: "some time after the June 7 meeting, I asked Mr. Kelly, if any decisions had been made with respect to Basic," and he said the answer was "no."

47. Caito testified that at the June 16, 1978 meeting of Muller, Ludwig and himself with general counsel Rose, "he advised that we should stay out of the market." Asked if he expressed a reason why they should stay out of the market, he answered, "No." Plaintiffs argue this advice of counsel shows the "clear materiality of the ongoing discussions between Basic and Combustion." Rose was not questioned about the giving of such advice. Concerning that June 16 meeting, he recalled Muller, Ludwig and Caito were asked by Kelly "if he could secure authority from Combustion to make an offer in the range of \$28, would that be interesting;" and they had answered "No." He added, "But my clear impression was that Mr. Kelly was not at that point authorized to make such an offer." In this context there is no foundation for the inference that Rose gave the advice because he believed the discussions had reached the point of a formal offer by Combustion. Hence, inferring materiality from Rose's cautionary advice is not permissible. Indeed, when Kelly called Muller on July 10, 1978 stating that he would "prepare an informal offer," Rose informed Muller there was "no need to tell board yet."

Muller was asked if following the June 7 meeting he had any contact with Kidder, Peabody "with respect to getting the evaluation." He answered "No." However, he said it was his "impression that Mr. Ludwig's department was in contact with Kidder, Peabody to continue the work on development of the appraisal by Kidder, Peabody." There is no evidence in the record, as plaintiffs contend, that following the June 7 meeting, "Basic contacted Kidder, Peabody and asked them to move along with the evaluation of the company." Moreover, Kidder, Peabody was not then informed of Combustion's interest in acquiring Basic. As seen, that did not happen until December 14, 1978.

With reference to the assignment of Carl Steinhouse, antitrust lawyer with Jones, Day, there is uncertainty in the record. Based on his memory crutch, Muller first testified that Steinhouse was to "compare the two refractories division [CE and Basic], in the light of a possible joining of forces, and what the implications would be in Washington by Federal Trade." He further testified that he did not direct Mr. Steinhouse to study the antitrust implications of C-E buying Basic, but just the two divisions together. Later he testified that Steinhouse's assignment "to CE was both-wise, the implications of Basic buying the CE refractories division, the implications of CE buying all of Basic."

Caito testified that Steinhouse was going to determine whether "[f]rom an antitrust standpoint . . . there was a problem with our product lines in terms of antitrust," that is, "whether they were competing product lines." Caito also testified that he recalled a discussion with Steinhouse about having him "look at U.S. Gypsum vs. Basic." He said he knew that U.S. Gypsum was "interested in Basic." The time records of Steinhouse include a June 16, 1978 entry of 1 1/2 hours "conference at Basic re possible merger with Combustion Engineering," a telephone conference with Caito on June 20, 1978, and a conference with Caito and Ludwig on June 28, 1978 in which there was "review of CE documents; review materials." In his deposition testimony, Steinhouse stated:

As best I can recall, the June work, from June 16 through June 28, related solely to consideration of the acquisition of the refractories division of Combustion Engineering.

Asked if during 1978 he was involved "in any antitrust review or analysis concerning CE's acquisition of Basic," he answered, "I don't recall any such involvement, no."

Steinhouse's testimony is at odds with Muller's testimony that Steinhouse's assignment "was both-wise, the implications of Basic buying the CE refractories division, the implication of CE buying all of Basic." This testimony may be combined with Muller's memory crutch entry concerning the June 28 meeting with Steinhouse and Caito, "CS says: go ahead." Even if this entry is construed the apply to C-E's acquisition of Basic, the furnishing of this antitrust advice did not commit Basic to a merger with Combustion.

At two different points in his deposition, Kelly was asked about the agreement at the June 7 meeting of Basic management to call him in two weeks "with a response" whether they "would be receptive to considering an offer from CE at some higher price." Each time he answered that they never let him know. However, Muller's memory crutch mentions two telephone conversations with Kelly. One June 20 he called Kelly asking for certain "SIC [U.S. Department of Commerce standard industrial classification numbers] and market share 1977." In the same conversation, Kelly suggested that

CE lawyers & BI lawyer to meet re FTC [Kaiser-Laveno proceedings]. Muller stated "yes, if J Day [Jones, Day] sees problem."

Three days later, Kelly gave Muller the dollars "of above three SIC [numbers]."

In the month of July 1978, Muller's memory crutch records a July 10, 1978 conversation with Kelly. It reads:

Kelly will prepare an informal offer. Advised against public disclosure. MM informs K that he'll ask Kidder Peabody for appraisal.

The record does not show that Muller or anyone else at Basic got in touch with Kidder, Peabody to ask for an appraisal.⁴⁸

In the context of active trading of Basic stock in the middle of July, Parker of Kidder, Peabody had talked with Matt Ludwig on July 20, and Marty Siegel talked with Max Muller. Among other things, Parker suggested to Ludwig that he talk with the specialist. He noted that Siegel "mentioned Combustion as possible white knight." He said this resulted from Jim Kelly, group VP at C-E, "dropping in off and on for ten years." He added, "this was news to me." However, this does not amount to a statement that Combustion had expressed an interest in acquiring Basic. As seen, Siegel stated that he first learned of that interest on December 14, 1978.

Kelly telephoned Muller on July 13, 1978. Muller's memory crutch thus recorded the conversation:

Kelly called: He will meet
with First Boston on 7-14 re Basic
Asked for latest figure in 1978 (said we gave him
4,600,000). I said he should use 5,500,000 plus.

As seen in plaintiffs' Ex. No. 106, the Insley financials, based on information provided Insley by Basic on March 22, 1978 or before June 7, 1978, budgeted Basic's income for 1978 at \$4,446,000. A Basic net income forecast, dated July 14, 1978, forecast 1978 income at \$5,364,000. Plaintiffs state in their brief: "earnings projections [for fiscal years ending 1978, 1979 and 1980] were subsequently given to Combustion." Plaintiffs intimate that the July 14, 1978 forecast was part of the "non-public financial information and projections concerning all segments and divisions of Basic's business" which Basic provided to Combustion to assist it "in preparing its offer for Basic." However, Insley, vice president and group controller for Combustion's industrial products group, stated that he did not see plaintiffs' Ex. No. 32 (the July 14, 1978 forecast)

48. Also on July 10, Muller's memory crutch shows that he called HCR (H. Chapman Rose) and "informed [him] of above [conversation with Kelly]. The next sentence states: "HCR agrees—no need to tell board yet."

before the December 1978 tender offer of Combustion. In his SEC testimony, Kelly testified that in the November 27 meeting with Basic management, they gave him "a document which had their profit plan or projections of where they were going . . . over the next year or so." Undoubtedly, this document was the July 14, 1978 forecast. Thus, any intimation that Muller gave Kelly this document in July 1978 is erroneous.

Nevertheless, Muller acknowledges that on July 13 in a conversation with Kelly, Kelly stated that the latest figure on 1978 given to him was \$4,600,000. At that point, Muller told him "he should use \$5,500,000 plus." In colloquy with counsel for plaintiff, Muller thus justified turning over this earnings projection, admittedly nonpublic information. He was asked if he gave these "projected profit figures . . . to assist [Kelly] in his evaluation." Muller answered, "If he were indeed thinking about having First Boston make an evaluation of Basic, I wanted First Boston, as their confidential advisor, to have the proper figure." To the question why did he care, Muller answered, "If any offer was forthcoming, as Mr. Kelly had indicated it might, I did not think it would be in the best interest of the shareholders to have that offer come forth as a low figure, as an unrealistic figure, as measured against current earnings." Explaining why that was "not in the best interest of the corporation or the shareholders," he answered:

Because an evaluation of Boston and a subsequent offer would reflect low earnings, and once that figure was out, it would be more difficult to negotiate it upwards than if First Boston had the proper figures in the first place.

He was then asked, "So you were contemplating having to negotiate with Mr. Kelly when the offer came out?" He answered:

I was not contemplating having to negotiate, because I had no idea what the offer would be. But if an offer came that was based on the lower earnings and, in analyzing that offer, we indeed found out it were based on low earnings, there would be reason to take issue with that offer.

Since a presentation on Basic was going to be made to First Boston on July 14, 1978 for the purpose of First Boston evaluating Basic stock and if, as Kelly indicated, Combustion intended to make an offer to Basic based on that First Boston evaluation, Muller's justification for giving Kelly the 1978 new profit projections can be accepted as done in the self-interest of Basic and its shareholders.

However, the trier of the fact need not accept Muller's answer when he was asked why his antitrust lawyer did not attend a meeting in New York with Combustion's antitrust lawyers. He answered that he was "very hesitant to have him participate, and he got me off the hook by being on vacation." When asked why he was hesitant in having him participate, Muller answered, "Our degree of interest was not such that I wanted to take any active part." The trier of fact would be entitled to find that in giving to Kelly the new projected earnings figures for 1978, he was intentionally furthering Kelly's plan, expressed on July 10, of "prepar[ing] and informal offer." A similar purpose explains Muller's telephone conversation with Kelly on July 18 when Kelly asked for and received from Muller Basic's sales for 1977 by "SIC Nos." On July 21 he forwarded to "Jim [Kelly] what we believed—accurate # sales 1977 v/s SIC numbers." On July 22 he wrote "Jim" that "we feel that all our products are now SIC'ed properly." In his SEC testimony, Muller confirmed this purpose. Asked why he gave Kelly this information, he answered:

Alright. Because he had announced that Combustion Engineering might prepare an informal offer; and that the Federal Trade aspect would be looked into once more. So, I was helpful to him in giving him those numbers.

By Muller giving to Kelly the updated 1978 income projection for his First Boston presentation and in giving Kelly all of the "SIC numbers" on Basic's 1977 sales, the trier of fact would be entitled to find that Muller was seeking to help Combustion Engineering come up with an offering price that would be acceptable to Basic. Furnishing the foregoing non-

public information to Kelly is determined to fall within the classification of "preliminary merger discussions," as characterized in *Staffin v. Greenberg, supra* at 13-15.⁴⁹

Muller's memory crutch indicates two telephone calls on July 18, 1978 from Kelly. Kelly's interoffice correspondence to president Santry of C-E, dated July 19, 1978 indicates that he talked to "Max Muller, president of Basic, today."⁵⁰

49. On July 14, 1978, Kelly made a presentation to the merger and acquisition specialists of First Boston, Combustion Engineering's investment banker. He delivered a slide presentation including the following chart:

Basic Management Goals:

- (1) Join CE
- (2) Get fair price
- (3) Avoid tax exposure
- (4) Tax free exchange

Kelly testified that the four "goals" were "his preception of what the people at Basic, that [he] was talking to, felt." Counsel asked Kelly:

Alright, so it is not a question of what Basic's management itself wanted to do as people—

Kelly answered, "Right." He later emphasized:

When I said, "they were favorably disposed to us," it was my opinion that all other things being equal or better, if they wanted to sell, which I had not determined, and if the price was right, that we would be an acceptable candidate for them, barring other reasons.

Asked if prior to July 18, 1978 he had discussed Basic management goals with Kelly, Muller answered "no." More particularly, he was asked, "Where it says goal No. 1, join CE, you never discussed that with Mr. Kelly?" He answered, "We did not."

Hence, Kelly's statement of "Basic Management Goals" are his subjective impressions which are not attributable to Muller or Basic management.

50. Southern New England telephone long distance billings to Combustion (telephone No. 329-8771) indicates a long distance call on July 19 to Cleveland, telephone No. 241-5000 (Basic), but none on July 18. Ohio Bell telephone records reveal a call on July 20, 1978 from Basic to Combustion ((203) 327-8771.) These records seem to conflict with Muller's memory crutch note that that two calls came from Kelly on July 18. Kelly's call to Muller was on July 19. What call occurred on July 20 from Basic to Combustion is not clear.

Previously, *infra* n.51 at 95, this court referred to part (b) of Muller's memory crutch for the first call he recorded under the date of July 18. That entry referred to Kelly's request for 1977 sales figures for certain SIC numbers.

In part "a)" of Muller's memory crutch for the first call dated July 18, he recorded:

Kelly called: a) what happened to BAI stock? M.M. said don't know. Kelly asked if NYSE had called. M.M. said yes, merely a routine inquiry.

The trading activity of Basic stock was the subject of conversation between Ludwig and Parker of Kidder, Peabody, *supra* at 88. He reported that Ludwig said "an analyst had reported rumor originating in Washington." Parker noted, "We had heard nothing." Parker suggested Ludwig "talk with specialist." This latter conversation coincides with Kelly's July 19 interoffice correspondence to president Santry that today he "learned (1) [Muller's] stock exchange specialist sees no concentrated buying."

The balance of Kelly's report to Santry reads:

- 2) Stock hit a high of 28-1/2 today and then dropped off to 27-6/8
- 3) Muller's answer to any outside inquiry continues to be that Basic management knows nothing that could be causing the rise.
- 4) His antitrust lawyer is on vacation until August 3.⁵¹

Kelly's interoffice correspondence to Santry concludes:

What this means, is that we will not make any proposals to Basic until mid-August at the earliest. I believe such a program works in our favor in that it gives a stock a chance to fall back to more reasonable levels.

51. Under Muller's memory crutch summary of the Kelly call of July 18, another call is summarized under the same date. It states:

K called M: re antitrust meeting on 7/28 in New York. To consider a[n] [illegible] meeting with government [antitrust] lawyers in Washington. K. said this would be a good time to "test" Washington on/account the Kaiser/Levino case.

Muller testified that his antitrust lawyer did not attend the meeting in New York with Combustion's antitrust lawyers stating, as noted earlier, "I was very hesitant to have him participate, and he got me off the hook by being on vacation."

5) Muller agrees that this slow, deliberate approach is the way to go.

Muller testified that he did not recall "talking with Mr. Kelly about the fact that the slow, deliberate approach was the way to go." Under Rule 56(e) of the Federal Rules of Civil Procedure, Kelly's statement that Muller agree "that this slow, deliberate approach is the way to go," qualifies as "admissible evidence," which may be considered in passing on defendants' motion for summary judgment. It is "relevant evidence" under Federal Rules of Evidence 401, and under Rule 803(6) and is "not excluded by hearsay rule." The question remains: what is its probative significance, construing it in the light most favorable to the plaintiffs?

Plaintiffs urge:

Because of Kelly's desire to allow Basic stock to "fall back to more reasonable levels" and because of Muller's desire to get Kidder, Peabody's valuation of Basic and to complete further preparations before a merger, Kelly and Muller expressly agreed that Combustion and Basic would follow a "slow, deliberate approach" in proceeding with the merger. They agreed that Combustion would defer its offer for Basic.

First of all, Kelly's interoffice correspondence makes clear that the last paragraph of "4)" was communicated solely to Santry. Written from the standpoint of Combustion, it is manifest that he is not saying that Muller agreed with Kelly's statement that "we will not make any proposals to Basic until mid-August at the earliest." Moreover, it is evident that he did not share with Muller his statement that "such a program works in our favor in that it gives a stock a chance to fall back to more reasonable levels." As seen in the November 27 file memorandum of Kelly, he informed Muller, Ludwig and Caito that Combustion "had not been back to them since this summer because of the relatively low P/E of CE stock made a stock-for-stock transaction unattractive to CE." The only conclusion the record permits is that it was Combustion, not Basic, which deter-

mined that "Combustion would defer its offer for Basic." In this context, the amorphous statement "Muller agrees that this slow, deliberate approach is the way to go," offers no probative support for plaintiffs' contention that "they [Kelly and Muller] agreed that Combustion would defer its offer for Basic."

Subsequent to the telephone conversation between Kelly and Muller on July 19, 1978, they had no further contact with each other until Kelly called Muller, stating that he was making a routine visit to Cleveland, and Muller agreed to see him on November 27, 1978. According to Muller's SEC testimony, "[t]o the best of [his] recollection [the telephone call] was a few days before the 27th of November." Indeed, except for a telephone conversation between Ludwig and Kelly on September 26, 1978 about the September 25 press release, the record discloses no telephone contact⁵² or other contact between Kelly and Basic Management from July 19, 1978 until the November 27 meeting.

Muller was out of the country in Europe between September 9, 1978 and October 12, 1978. In a town called Gosport on the southern coast of England, he received a telephone call from Ludwig. Ludwig informed him that he was in the presence of a lawyer from Jones, Day. They read to him the text of a proposed press release. Ludwig told him that he had received an inquiry from the New York Stock Exchange concerning trading activity in Basic stock. It is apparent that Basic's counsel, Jones, Day, recommended the issuance of a release in light of the recent trading activity and that Basic's management concurred.

52. Looking at the calls from C-E ((203) 329-8771) in Stamford (Kelly's base of operations) to Basic ((216) 241-5000) in Cleveland, there were no calls from July 19, 1978 to November 9, 1978. There were no calls from Basic in Cleveland ((216) 241-5000) to C-E ((203) 329-8771) in Stamford from July 20, 1978 to November 14, 1978. Ludwig's diary shows a "Tel" with several persons, including "Jim Kelly" on September 26, 1978. It was Ludwig's recollection that the September 26 calls were about the "news release" and that he received the calls. Kelly had no recollection of a telephone conversation with Ludwig in September, about the time of the news release.

Transmitted by the Dow Jones news service on September 26, 1978, Basic's September 25, 1978 news release read in full:

CLEVELAND, OHIO—Basic Incorporated (NYSE-BAI) today reported that, although confident of the company's current and future business prospects, management is unaware of any present or pending company development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days.

In the first half of its current fiscal year, ending June 30, the company reported earnings per share of \$1.81 compared with earnings per share of \$1.45 in the first half of 1977 and \$1.37 in the last half of 1977. Sales in the first half of 1978 were \$40,007,000 compared with \$35,300,000 in the first half of 1977 and \$31,447,000 in the last half of 1977.

Basic Incorporated produces refractory materials and chemical and electronic products.

Plaintiffs assert that the second half of the first paragraph was "false and misleading" because

defendants knew that the investment community and the holders of Basic's securities believed or had reason to believe that there were some significant pending corporate developments which would affect the prospects for Basic [including] . . . (a) the continuing negotiations with Combustion for an acquisition of Basic at a price far in excess of current market prices and (b) the developments in Basic's business which had resulted in dramatically increased sales and earnings for 1978 and subsequent years.

In moving for summary judgment, defendants argue that the release was true and they have presented evidence to show that they were not "aware of any present or pending company development to explain the unusual trading activity and price fluctuation in company shares that [had] been experienced in

the past few days." The sworn affidavits of Muller, Ludwig, Caito, Rose, and the other defendants all contain the following statement:

During the period October 1, 1976 through December 15, 1978, I was not aware of any present or pending corporate developments within Basic which would account for the trading activity or price fluctuations in Basic's stock.

The affidavits of Muller, Ludwig, Caito, Rose and Wilson further state:

At no time during the period October 1, 1976 through December 15, 1978 did I associate any contacts between C-E and Basic representatives with any trading activity or price fluctuations in Basic's stock.

The other evidence in the record in no way contradicts or makes an issue of fact as to these affidavit statements. On September 25, 1978, unusual activity and price fluctuations were taking place in the trading of Basic stock. The activity prompted an 11:25 a.m. call by David Dolan, the NYSE's liaison representative in charge of Basic stock, to Ludwig.⁵³ Dolan's notes of the call state:

No corporate developments—has considered calling the specialist. Will consider & probably make a "no corporates" statement.

According to Ludwig, after learning of the inquiry, he "got a hold of Young [public relations firm] pretty promptly" and

53. At his deposition, Ludwig testified that it was Thomas, and not he, who spoke to the exchange representative. Ludwig's memory was faulty on this point. Thomas testified that he was away on vacation that day and called in to ask whether there were any developments because he had noted in the paper "the wide fluctuation and activity in the stock." Thomas testified as to Ludwig's response:

He said no, nothing is going on that we know of.

Moreover, Dolan's "stock watch" form records that he spoke with "Matthew Ludwig - S.V.P. Fin."

Davis Young, Steinbrink (Jones, Day) and he met. Since Muller was vacationing in Europe at the time, the three called him by phone. Ludwig testified:

Generally, he [Muller] thought the release was appropriate under the circumstances.

Muller recalled that he was in England when the call came through. Muller testified:

He [Ludwig] said that the lawyers or the lawyer advised Basic to make a release. . . [colloquy of counsel] . . . in the light of a recent Basic stock flurry.

Muller recounted that he helped prepare the release over the phone.

Nothing in the evidence suggests that any of Basic's officers or attorneys had any knowledge of the reasons for the September 25, 1978 flurry. The deposition testimony of Steinbrink, the Jones, Day attorney who helped prepare the news release, was that neither Ludwig nor Muller knew of any company developments which could account for the activity. Asked:

Did you, prior to or after your telephone conference with Mr. Muller, inquire of Mr. Ludwig whether he had any knowledge of any company developments?

He responded:

A. Yes, I believe we talked at some length about what was going on that might give rise to the trading activity at the moment. There were two possibilities that we identified.

One was that Basic simply was having a very good year financially. Their earnings had been up considerably during the course of the year, that fact was known, the results for the first half had been previously announced, and things simply were looking very good for the company from that perspective.

Continuing, Steinbrink stated:

The second factor of which we were aware was that there was a general phenomenon at this point in time in which a lot of issues traded on the New York Stock Exchange and other markets were jumping up and down based upon investors' guesses, assumptions, whatever, that a takeover was going to occur. These market swings would heat up for a few days and then nothing would come out of it and they'd die down and go away.

That activity seemed to be very heavy, in other words, there seemed to be a lot of it at this point in time with many different companies, and it seemed to us that Basic was being affected by that type of trading activity.

Steinbrink further testified that Muller was called in Europe because "Matt Ludwig was especially concerned that Max might know something that Matt didn't know." Moreover, when Ludwig was asked at his deposition:

Mr. Ludwig have you ever learned what caused the trading activity which occurred on or about September 25, 1978?

He stated, "No."

Plaintiffs contend that

during the very period when Basic was issuing its disclaimers to the public in both written public statements and Thomas's responses to telephone inquiries, Muller was selectively leaking non-public information to Ted Mayer which directly resulted in huge trading activity in Basic stock by Legg, Mason.

As to whether the contracts between Mayer and Muller rendered Basic knowledgeable as to the abnormal trading activity that preceded September 25, 1978, attention will be centered on that period. Mayer, an analyst for Legg, Mason, had a specific recollection of only one telephone conversation with

Muller (July 10 or 12).⁵⁴ Mayer indicated to Muller that "there was a rumor around that the company [Basic] was going to be acquired by a West German company and that the rumor had as its source a Washington attorney." He stated that Muller responded:

Something to the extent those darn lawyers. They always think they represent somebody. He said if I have any negotiations with any company, I can do it or they can do it directly, president to president.

Mayer indicated that Muller further responded by saying that they had had inquiries. When Mayer asked, "like who," Muller then "indicated three foreign companies and didn't identify them by name, and two domestic companies which he did identify by name [Easton and TRW]."⁵⁵ Mayer was asked the question, "Is the July 10th or 12th phone call the only time Mr. Muller ever named a company to you with respect to either inquiries being made about a Basic merger or the possibility of a Basic merger?" He answered, "To my recollection, that is the only time he gave me any information."

Plaintiffs contend that:

[T]here were "at least half a dozen occasions" between the first conversation in or about January, 1978 and the last conversation in or about November, 1978 when he asked Muller about approaches and Muller confirmed that the company had, in fact been approached. (Mayer SEC Tr. 159-68, 157-80.)

54. Mayer's telephone records showed that he called Muller on both July 10 and July 12, but he was not sure as to which of these calls he had a specific recollection. The records also show he called Muller on July 27, but he had no recollection of this conversation.

55. Later Mayer gave a different version of how this conversation proceeded. He said:

If I've indicated that I did ask a specific question, then I believe I'm wrong. The information came out of him when he was angry about my asking him about a rumor. I really can't remember the specific details of how that exactly came out.

Mayer testified that the general question he normally asked Muller was, "Have there been any inquiries from companies interested in acquiring [Basic]?" Further elaborating, Mayer testified:

In response to that, he [Muller] would say, yes, there have been inquiries. There are always companies interested in Basic.

At this point Mayer did not fix the time of Muller's quoted answer. However, earlier interrogation (page 166 of Mayer's SEC testimony) provides a time period:

Q. Is this the conversation that you earlier testified you think occurred two to three months before December?

A. Yes.

• • • • •

Q. What was the substance of this conversation that occurred some time between July and December, probably two to three months before December, as you recall?

(Witness and counsel consulting.)

The Witness: I can't remember the conversation specifically or exactly what was discussed in the conversation but I believe that I asked, "Have there been any inquiries from companies interested in acquiring Basic?"

By Mr. Wachterman:

Q. Do you recall anything that Mr. Muller said during that conversation?

A. There are always companies interested in Basic.

Hence, it is concluded that Mayer's testimony does not support plaintiffs' contention that Muller's statement, "there are always companies interested in Basic," occurred "[on] 'at least half a dozen occasions' between the first conversation in or about January, 1978 and the last conversation in or about November, 1978."

In other testimony, Mayer indicated that he had first heard rumors of a West German acquisition of Basic some time in either May or June of 1978. He also said that around the

May-June period he had heard a rumor that Hepworth, an English-based company was "interested in Basic, in acquiring them." He heard this from a Legg, Mason registered representative in Baltimore, Maryland.

Mayer testified that he "indicated to the Legg, Mason sales force on numerous occasions that one of the reasons I recommended and continue to recommend Basic, Inc. was that it was an acquisition candidate." Mayer testified that Muller's information, given him on July 10 or July 12, "reinforced [his] original recommendation" that "the company was an interesting acquisition candidate."

At the next weekly sales meeting of Legg, Mason salesmen, Mayer said that he told them, in substance, "that in a recent contact with a company, the management had indicated that they had some inquiries from companies interested in acquiring them."⁵⁶ Asked if he "mentioned the names of the companies that Mr. Muller had told [him]," he answered, "I am not certain that I did. But I'm not certain that I didn't." He also passed on the information both to "the reps. within the firm that . . . had a continuing interest in Basic" and also to "brokers that [he] remembered had a big interest or a continuing interest in the stock."

Plaintiffs state that following "Mayer's report of that telephone conversation to the Legg, Mason brokers, Legg, Mason's trading activity in Basic stock soared by more than 1,000 percent." Plaintiffs further state that "[i]n contrast to average daily net purchases of about 600-800 shares, Legg, Mason purchased a net of more than 8,300 shares of Basic stock on behalf of its customers on July 14 alone."

56. Significantly, Mayer did not testify that he passed on the other more general statement of Muller that "there are always companies interested in Basic." Thus, even if Muller made that general response to Mayer before September 25 (and it is more likely it happened between September 25 and December 18, 1978), Muller did not pass on that statement to the Legg, Mason personnel. But if in fact he did, any effect on the trading of Basic securities was combined with the effect of the Basic information which Mayer stated that he did transmit to Legg, Mason personnel.

Plaintiffs' calculation of "a net of more than 8,300 shares of Basic stock" purchased by Legg, Mason customers on July 14, while accurate for that day, will be examined as part of the Basic trading activity by Legg, Mason customers in the months of June through September 21 (the last trading day revealed in plaintiffs' Ex. No. J). In the month of June, Basic stock was traded on 15 trading days for a net of minus 150 (excess of sales over purchases). In July, Legg, Mason customers bought 35,162 shares on 16 trading days. Average daily net purchases equaled 2,198 (rounded) shares for each of the trading days. In August, Legg, Mason customers made net purchases of Basic stock totaling 14,655 shares on 22 trading days. The average daily net purchases were 666 (rounded) shares for each trading day. In the month of September, Legg, Mason customers purchased a net total of 3,760 Basic shares on 10 trading days. The average daily net purchases were 376 (rounded) shares per trading day.

These comparative figures for the month of June, July, August and September indicate that Mayer's transmission of the information he gleaned from Muller on July 10 or July 12, undoubtedly caused the net purchase by Legg, Mason customers to increase to 8,300 plus shares on July 14. However, these calculations show, without dispute, that the trading effect of the non-public information which Mayer obtained from Muller and communicated to Legg, Mason salesmen, representatives and interested brokers had subsided by the end of August. Moreover, assuming 600 to 800 shares are the average daily net purchases of Basic stock by Legg, Mason customers in the relevant period, the September average of 376 shares per trading day was about 50 percent of average daily net purchases. Thus, it is evident that whatever effect Muller's transmittal of non-public information to Mayer may have had on the increased purchase of Basic stock by Legg, Mason customers in July, that effect was fully dissipated in September 1978.

Mayer's testimony, however, reinforces the undisputed fact in the record that none of the rumors of companies interested in acquiring Basic at any time linked Combustion Engineering

to Basic. Mayer was asked, "You never heard any rumors about Combustion Engineering and Basic, Inc. being related in any way prior to December 15, 1978?" He answered, "I never heard any rumors connecting the two companies." Asked if he ever indicated "to anybody prior to December 15, 1978 that Combustion Engineering could in any way be possibly interested in Basic, Inc. as an acquisition candidate," he answered, "No, I did not."

In the relevant period from July 1 through September 25, 1978, the single conversation of July 10 or July 12 between Mayer and Muller in which Muller gave non-public information to Mayer, does not provide the frequency needed to support the charge that Muller was "selectively leaking non-public information to Ted Mayer."⁵⁷

57. Plaintiffs assert that *Schlanger v. Four Phase Systems, Inc.*, 81 Civ. 7798-CLB (S.D.N.Y. Mar. 7, 1984), supports their contention that summary judgment should be denied. In *Schlanger*, plaintiffs represented a class of stockholders who sold their Four Phase stock between the time of a December 2, 1981 public announcement by defendant Four Phase and December 10, 1981, when defendant announced its proposed merger with Motorola. Plaintiffs sued Four Phase, its individual officers and directors. They alleged that defendants violated Rule 10b-5 by issuing the following December 2 public announcement, made in response to a NYSE inquiry after "a steep and sudden rise" in the market price and trading volume of Four Phase stock:

R. Frederick Hodder, Treasurer of Four Phase Systems said the Company is not aware of any corporate developments which would affect the market of its stock.

Id., slip op. at 2. Plaintiffs claimed that the statement was false and that it contained a material omission because word of ongoing merger negotiations had leaked, causing the increase in trading and price. The December 2 statement then allegedly "artificially depressed the market price of Four Phase," causing those members of the class who sold their stock between then and the December 10 merger announcement to suffer "damages or a lost benefit which would have been enjoyed had they awaited the merger." *Id.*, slip op. at 3-4.

The defendants argued that since no formal offer had been made at the time of the statement, there was no duty to disclose their merger discussions with Motorola. Therefore, the statement was neither a material misstatement nor a material omission.

Summary judgment was denied in *Schlanger* because the court concluded that genuine issues of material fact remained in the record. The court noted

Although the showing that transmittal of that information to Mayer may have led to an increase in a purchase of Basic stock by Legg, Mason customers, particularly on July 14, 1978, the totality of the evidence relating to this incident offers no proof of the falsity of the September 25, 1978 public statement that "management [including Muller] is unaware of any present or pending corporate development that would

several important facts in the record that distinguished Schlanger from Staffin and Reiss, *supra*. The defendant corporation made the denial of corporate developments in the midst of "a steep and sudden rise" in the trading of its stock. It was undisputed that "high level discussions and negotiations" had occurred between Four Phase and Motorola and the avenue of discussions had not been closed at the time of the statement. Moreover, the court observed that "[n]o explanation of the price activity prior to December 2 is suggested, other than leaks of the existence of the merger discussions." *Id.*, slip op. at 10. These and other facts, according to the court, created an issue of fact as to whether defendants had knowledge of the leaks, and if so, whether the statement was made to mislead the public in order to stabilize Four Phase's stock price so that the merger would be preserved. *Id.*, slip op. at 16.

Like Staffin and Reiss, *supra*, the present case is distinguishable from Schlanger. In Schlanger the court was concerned that inside leaks of "high level discussions" caused the Four Phase stock's trading and price increases. In the present case the three public statements also denied that the increase in trading in Basic stock was due to significant corporate developments. Theodore Thomas, secretary-treasurer of Basic, testified that during periods of high activity in Basic stock he answered from one to fifteen calls a day from shareholders and stockbrokers. "The calls had to do with questions of whether there were any unusual company activities or mergers, rumors to account for [the increased trading in Basic stock]." He stated that in 1977 and 1978 he had heard rumors by telephone from brokers and stockholders about companies "being involved in merger rumors with Basic," *supra* at 60-61. While most were unidentified Swiss, Belgian, English and domestic companies, two domestic companies that were identified were Flintkote and Hanna Mining. But he "never heard a rumor about Combustion."

As just seen in the text, the court has found that with reference to the relevant period of July 1 through September 25, 1978, the evidence does not support the charge that Muller was "selectively leaking non-public information to Ted Mayer." In any event, both Ted Mayer and Norman Oremland, analyst and broker with the stock brokerage firm of Legg, Mason, testified that while they had heard rumors of unidentified companies and two or three identified companies wanting to merge with Basic, Combustion was not mentioned in any of these rumors.

There is no evidence in the record of any leak of information about Basic and Combustion discussions during the 1977 and 1978 period of increased trading in Basic stock.

result in the abnormally high trading activity and price fluctuation in company shares that have been experienced in the past few days." Mayer's acknowledgment that he "never heard any rumors about Combustion Engineering and Basic, Inc. being related in any way prior to December 15, 1978," coming from a stock analyst who is closely following Basic stock, provides unrefuted relevant evidence that the contacts between Kelly and Muller in July 1978 in no way caused or contributed to the "abnormally heavy trading activity and price fluctuation" in Basic shares in the days preceding September 25, 1978.

The evidence in the record does not present a genuine issue of material fact to support the plaintiffs' claim that the Basic public release of September 25, 1978 was false. On the undisputed evidence it is determined as a matter of law that the public statement was true.

With reference to the Basic press release of September 25, 1978, plaintiffs further claim that

defendants knew that the negotiations with Combustion were nearing completion . . . defendants knew that investors would rely upon their disclaimers of any present or pending company development in making their investment decisions. Indeed, their statements were issued with the intention of influencing the market activity in and the price of Basic's securities.

Accordingly, plaintiffs assert that "defendants had a duty as of the September 26, 1978 statement, averred in paragraph 30 hereof, to disclose the facts known to them, as averred in paragraph 20 hereof, in order to make that disclaimer not misleading." In paragraph 20, among other things, plaintiffs assert that defendants

fail[ed] to disclose to them material facts about the business, affairs and prospects of Basic which were known to defendants, including, among other things, (a) the continuing negotiations with Combustion with respect to the proposed acquisition of Basic by Combustion at a price far in excess of the then current market

price of Basic securities and (b) financial data respecting revenues and earnings and projections prepared by defendants as early as July 1978 which showed a dramatic improvement in Basic's sales, income and earnings per share for 1978 and subsequent years, including earnings for 1978 of \$5.00 per share as compared to \$2.82 per share for 1977. Disclosure of such facts was necessary to make the disclaimers made by defendants not misleading.

These claims will be considered in light of the relevant corporate events which occurred prior to September 25, 1978, as these events have been heretofore chronicled and evaluated by the court based on the pertinent evidence.

Summarized, the principal corporate events are the exchange of financial information between Basic and Combustion Engineering which occurred, inclusively, between March 22, 1978 and June 7, 1978, and Kelly's indication on June 7 that he would suggest consolidation "by CE buying Basic" and he "thought that \$28/share in cash or CE stock would be a price [he] could recommend to [president] Santry." As Kelly recorded the reaction of Basic management, "[t]hey then pointed out that if they were to consider a sale, a price as low as \$28 would be out of the question." Four telephone conversations between Kelly and Muller occurred in the month of July. In the first, on July 10, Kelly indicated that he would "prepare an informal offer." Muller imparted to Kelly non-public Basic 1978 income projections and 1977 sales figures by telephone and by letter that helped Kelly prepare an informal offer. As previously held for each of these separate corporate events, it is now determined collectively that, considered most favorably for the plaintiffs, they represented preliminary merger discussions between Combustion and Basic. However, these corporate events cannot be legally characterized as negotiations which might imminently produce an agreement in principle, even though on the basis of the July contracts between Kelly and Muller, Basic management then believed that Kelly might get back to Basic with an informal offer. Muller's belief when Kelly visited Basic on November 27 was that he "would

undoubtedly broach the subject [of an offer of Combustion]." Yet, at no time, even in the meeting of November 27, was it reasonably certain that if a formal merger offer were to be made by Combustion, that the tender offer price would be acceptable to Basic. Accordingly, applying the principles of *Staffin v. Greenberg, supra*, these corporate events were not "material" within the meaning or contemplation of Rule 10b-5. Hence, plaintiffs have not produced evidence which shows as of September 25, 1978: (1) the existence of Basic's "continuing negotiation with Combustion;" or (2) that with reference to the contacts between Combustion and Basic, a duty rested on Basic "to make their flat disclaimer of the existence of any such negotiation not misleading."⁵⁸

58. Plaintiffs also allege that this second statement along with the November 6, 1978 statement was false and misleading because Basic had prepared, yet did not disclose to its stockholders, its earnings projections. Plaintiffs claim that Basic knew that "the company's financial condition and radically changed financial picture," as evidenced by the projections, were significant corporate developments which affected trading in Basic stock. It must be noted that these 1978 income projections were speculations as to future earnings and did not reflect Basic's actual 1978 income or earnings at the time the statements were made. In *Marsh v. Armada Corp.*, 533 F.2d 978, 986-87 (1976), *cert. denied*, 430 U.S. 954, the Sixth Circuit rejected a similar claim by shareholders:

The failure to make a projection of future earnings of an acquired company in a merger proxy statement is not actionable under Rule 10b-5. In *Arber v. Essex Wire Corp.*, 490 F.2d 414, 421 (6th Cir. 1974), we stated:

[T]he law mandates disclosure only of existing material facts. It does not require an insider to volunteer any economic forecast.

Cf. James v. Gerber Products, 587 F.2d 324 (6th Cir. 1978) (non-disclosure of interim earnings figures). Had the projections been incorrect, the disclosure of these projections may have misled those who sold their stock based on the speculative information. As the district court observed in *Staffin v. Greenberg*, 509 F.Supp. 825, 837 (E.D.Pa. 1981), *affd., supra*, 672 F.2d 1196 (3d Cir. 1982):

It is well established that speculative information regarding future prospects, especially a projection on future earnings, is not material and need not be disclosed and in many cases may itself be misleading.

Therefore, the court finds that Basic's nondisclosure of its favorable internal 1978 income projections was justified and did not make its public

C.

The third public statement which is the subject of the plaintiffs' amended complaint, is the statement which appears in Basic's "nine months report" dated November 6, 1978 that

with regard to the stock market activity in the company shares we remain unaware of any present or pending developments which would account for high volume of trading and price fluctuations in recent months.

Except for a telephone conversation between Ludwig and Jim Kelly on September 26, 1978 that related to the press release of September 25, 1978, there was no contact between Kelly and Basic management between September 25, 1978 and November 6, 1978. Thus the November 6, 1978 statement issued as part of the "nine months report" was more attenuated *vis a vis* the July discussions between Kelly and Muller. As to the reason for incorporating the statement in the "Nine Months Report," secretary-treasurer Thomas stated: "purely as a means of communicating with the shareholders, to make sure that everyone got the same message." He further explained:

Just because of the activity in the stock, and some shareholders called in inquiring about the activity, and this is a good way to answer all of them.

Before the report was released, it was reviewed by Basic's counsel, H. Chapman Rose. Rose testified:

I certainly participated in reviewing it, because I was acting as the Chairman of the Audit Committee which reviewed the third quarter report. And it had my full approval, then and now, as did the [September 26, 1978] press release.

statements false or misleading. In fact, Basic's statement that management was "confident of the company's current and future business prospects" is itself evidence that the omission of the projections was not intended to misrepresent Basic's financial stature.

In preparing the statement, Muller testified that discussions between Basic and CE did not come up. Rose further testified:

My general impression is that I, in the light of the discussions of June and early July inquired from time to time whether anybody heard from Mr. Kelly and whether there was any progress, and that the answer was always no.

He further stated: "We [Muller, Ludwig, and Rose] exchanged impressions that possibly the improvement in the stock of Basic had cooled off Mr. Kelly's interest." As seen, the evidence shows that there were no contacts between Muller and Kelly between July 19 and November 27, 1978.

The court has already ruled that the contracts between Kelly and Muller in July 1978 could not be treated as negotiations destined, with reasonable certainty, to become a merger agreement in principle between Combustion and Basic simply because in July, Basic management expected Kelly to get back to them with an informal offer of merger. This ruling is not altered by director Wilson's notes of a telephone conversation on November 21, 1978 between Muller and himself. As with his other telephone conversation notes, these are not admissible, n.28, *supra* at 42.⁵⁹

59. Assuming that the Wilson telephone notes of the November 21, 1978 telephone conversation would be admissible at trial, plaintiffs read the exhibit as saying that Muller "told him that Combustion would be making an offer of \$45-\$50 per share for Basic." However, Wilson did not so testify. Asked to explain his notes, he first explained the entries above the last three lines. They related to projected per share earnings and the possibility of increasing Basic's dividend. The next two lines read, "Jim Weeks Comb E to Cleve Mon Nov-27." The witness cannot remember anything about the name Jim Weeks. He said "either then or since, I have never heard the name." Assuming that he wrote down Jim Weeks when he should have written down Jim Kelly, it is the last line of the notes which becomes critical. After the letters C.E. appear "45 [arrow] 50." Then appears four characters which plaintiffs read as an abbreviation for dollars. However, Wilson reads them differently. He testified:

. . . and "45-50" and those light letters after that I believe—I believe is after the "50" was a cents mark. That's why I write cents, and I just

Upon the same grounds and for the same reasons pronounced in finding no genuine issue of material fact as to plaintiffs' claims as to the statement of September 25, 1978, it is concluded and determined that "in the light of the circumstances under which it was made," no genuine issue of fact exists as to Basic's November 6, 1978 statement "not being false or misleading." The court specifically determines that the November 6, 1978 statement, a part of the "nine months report" sent to stockholders, was neither false nor misleading.⁶⁰

III.

In *Dirks v. S.E.C.*, 51 U.S.L.W. 5123, 5127, n.23 (July 1, 1983), the Supreme Court observed:

Scienter—"a mental state embracing intent to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, n.12 (1976)—is an independent element of a Rule 10b-5 violation. See *Aaron v. SEC*, 446 U.S. 680, 695 (1980).

Gainsaying the dissenter's contrary view, p.5130, n.10, the court continued:

[M]otivation is not irrelevant to the issue of *scienter*. It is not enough that an insider's conduct results in harm to investors; rather a violation may be found only where there is "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.

ran it together rather than making a "C" and running a line through it, and the last word at the end I believe is "dividend," and I don't recall why I wrote that down, or what was being told to me which prompted me to write that down.

60. As to plaintiffs' claim that Basic's nondisclosure of its favorable earnings projections in the "nine months report" made its statement misleading, the court denies this claim, adopting the findings in part II.B.

Hochfelder, supra, at 199. In the Sixth Circuit, the scienter requirement can be met in Rule 10b-5 cases by proving recklessness. *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979).⁶¹ *Accord, Davis v. Avco Financial Services, Inc.*, Nos. 82-3553, 82-3572 (6th Cir. 1984). While plaintiffs have not specifically alleged that defendants acted "recklessly," the court will apply the "recklessness" standard in examining the principal evidence on which plaintiffs rely to prove scienter. As determined in part I, none of the three Basic statements at issue violated Rule 10b-5. None were false or misleading, the essential element of the offense. Hence, the issuance of the statements, found to be true, does not provide evidence of scienter.

As evidence to prove scienter, plaintiffs urge:

The record shows that Kelly and Muller discussed the subject of public disclosure, and that Kelly urged Muller not to make public disclosure because of his concern about the effect that disclosure would have on the price of the merger.

This part of the argument is based on Muller's July 10, 1978 conversation with Kelly, as recorded in his memory crutch. The notes read:

Kelly will propose an informal offer. Advised against public disclosure.

61. In *Mansbach, supra* at 1025, the court addressed the recklessness standard:

It is not necessary for us to precisely define what constitutes reckless behavior since it is ultimately a factual determination which will necessarily vary from case to case. As a general matter, however, we express our agreement with the standard articulated in *Sundstrand, supra*, 553 F.2d at 1045. The seventh circuit there held that recklessness was highly unreasonable conduct which is an extreme departure from the standards of ordinary care. While the danger need not be known, it must at least be so obvious that any reasonable man would have known of it.

Plaintiffs then argue:

Because of Kelly's concern, Muller reassured Kelly that no disclosure would be made, and that he would continue to issue denials in the form in which they had previously been made.

Actually this argument is a reference to Kelly's July 19, 1978 interoffice correspondence to president Santry. In the July 19 interoffice correspondence, as seen, Kelly told Santry:

Muller's answer to any outside inquiry continues to be that Basic management knows nothing that could be causing the rise.

The unspoken premise of plaintiffs' argument is that Muller's acceptance of Kelly's counsel against public disclosure of the continuing discussions between himself and Basic management offers proof of scienter that Basic intentionally or recklessly violated Rule 10b-5. However, this court has concluded that non-disclosure did not violate Rule 10b-5, because the information has not been found to be material. Hence, the act of nondisclosure cannot constitute proof of scienter, *i.e.*, that the defendants were engaging in either intentionally misleading the investment public or that nondisclosure was "highly unreasonable conduct" with reference to the investment public.

In plaintiffs' reference to Kelly's July 19 interoffice correspondence to Santry, apparently they seek evidentiary support in the following statement of Kelly:

What this means, is that we will not make any proposals to Basic until mid-August at the earliest. I believe such a program works in our favor in that it gives the stock a chance to fall back to more reasonable levels.

5) Muller agrees that this slow, deliberate approach is the way to go.

There is nothing in the record to show that Muller favored giving "the stock a chance to fall back. . . ." Indeed, Kelly's November 27, 1978 file memorandum reveals proof to the

contrary. In their November 27 meeting, when Kelly suggested a price of \$35, they reacted:

They didn't reject such a number but felt the price too low compared with market history over the last six months.

They did not believe the market price high in relationship to their current earnings outlook of close to \$5 per share. They stated that they do not operate at a high market level because of merger rumors. They thought the better market performance resulted from their good earnings performance and prospects and the recognition of the fact that their mineral reserves are substantially undeveloped.

Notably, they told Kelly that "they had never heard any rumor about acquisition by CE."

Moreover, it is not apparent why Basic would favor depressing the price of their stock to permit C-E to acquire Basic for anything less than its real value. The consistent testimony was that Basic wanted any offer to reflect its true value as evaluated by Kidder, Peabody to be sure that any offers would be high enough. Kidder, Peabody's negotiations with First Boston between December 15 and December 19, resulting in a higher price, is the best proof that Basic did not issue the public statement to depress the price below its true value.

As further proof of scienter, defendants claim that Basic falsely told the New York Stock Exchange, who called Basic pursuant to "stock watch alerts," that there were "no corporate developments," "no merger or acquisition plans," no "rumors" of which they were aware, and no "developments" relating to any of Basic's prior public statements. On July 14, David Dolan, the New York Stock Exchange's liaison representative, spoke by telephone to Thomas of Basic when its stock rose 3-1/8 points to 26-7/8, a new high, on trading volume for Basic of approximately 18,200 shares. In his deposition testimony, Dolan relied on his SEC affidavit, because he did not "presently recall the exact words" that Thomas used when Dolan called him. His affidavit records:

"In this case, Mr. Thomas responded that there were no corporate developments." Plaintiffs also point to Dolan's answer to "absolutely not" to the question, "Did he tell you anything about discussions between Basic and any other company concerning the possibility of a merger or acquisition or tender offer involving Basic?" Since the court has ruled that there was no duty publicly to disclose the July preliminary merger discussions between Kelly and Muller, the failure of Thomas to report these to Dolan did not render false or misleading Thomas's denial of "corporate developments." Moreover, since one of the rumors which may have been circulating about a possible acquisition of Basic on or about July 14 could have involved Combustion Engineering, any failure of Thomas to mention "rumors" is immaterial. The same conclusions apply to Ludwig's September 25, 1978 telephone response to Dolan on a "stock watch" inquiry "that there were no corporate developments to explain the [Basic stock] trading activity," as recorded in Dolan's SEC affidavit. The answer of Ludwig was not false or misleading.

Attempting further to show that Muller acted with scienter, plaintiffs point to his discussions with Legg, Mason broker Ted Mayer. Plaintiffs state:

The leaks by Muller generated huge trading by Legg, Mason in Basic stock, allowing Legg, Mason's shareholders to profit while members of the plaintiff class sold their shares in reliance upon defendants' systematic denials.

The telephone conversation on July 10 or July 12, 1978 in which Mayer quoted Muller as mentioning three unnamed foreign companies and two named domestic companies as being interested in Basic was the only call in which non-public information was revealed by Muller to Mayer in the relevant period of July 1, 1978 through September 25, 1978. It has previously been held not to constitute "selective leaking" by Muller to Mayer. Mayer, a stock analyst, edited the Hudson Research Report for Legg, Mason. This ruling is made in the

light of the observations in *Dirks, supra*, of the role of the market analyst:

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," 21 S.E.C., at 1406, and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. [Footnotes omitted].

51 U.S.L.W. at 5126. The Court then summarized:

It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

The Court subsequently recognized that "not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. See 15 U.S.C. § 78t(b) (making it unlawful to do indirectly 'by means of any other person' any act made unlawful by the federal securities laws)." *Id.* at 5126.

The undisputed evidence shows that in contacting Muller and attempting to obtain an explanation for Basic's trading activity, Mayer seemed to be performing the function of the market analyst described by the Court in *Dirks*. The Court also indicates that corporate executives may properly provide information to market analysts. However, market analysts and corporate executives run afoul of the federal securities laws

when either exploits the disclosure of the non-public information for "their personal gain." The record here is devoid of proof of improper collusion between Mayer and Muller, and there is no evidence which indicates that Muller exploited Mayer's initiated contacts for his "personal gain."

The court has previously pointed out that there is no evidence of insider trading by any of the defendants in this case. Defendants' sworn affidavits are uncontroverted on this point, and plaintiffs do not assert evidence which challenges these affidavits. As the Court stated in *Dirks, supra* at 7127, n.23 (July 1, 1983): "[M]otivation is not irrelevant to the issue of scienter." The record is barren of any motive on Basic's or any of the individual defendants' parts to "manipulate, deceive, or defraud" the investing public.

Examining the evidence in the record in the light most favorable to plaintiffs, the court determines that no genuine issue of material fact exists as to any of the defendants having intentionally or willfully acted to "deceive or defraud investors" *Hochfelder, supra*, at 199.

Nor does the present record give any indication of reckless conduct on the part of Basic or the individual defendants. As previously discussed, it is undisputed that Muller obtained approval from Waddell of Flintkote with reference to the October 21, 1977 release. Similarly, in September 1978, when the NYSE suggested a public statement to quell the unusual trading in Basic stock, Muller was called in Europe to ensure that there "were no present or pending company developments to account for the trading activity."⁶²

Neither the actions of Basic or of any of the individual defendants constitutes "highly unreasonable conduct which [was] an extreme departure from the standards of ordinary care." *Mansbach, supra* at 1025. Therefore, it is determined

62. Further, the record reveals that Rose, as Basic's counsel, constantly monitored Basic's activities to ensure that they complied with the law. Rose reviewed and approved both the September 1978 and November 1978 statements and advised Muller that it was not necessary to reveal to the board of directors that Kelly promised to make an informal offer to Basic.

that no genuine issue of material fact exists as to any of the defendants having acted recklessly.

In short, it is concluded that there is no evidence that the defendants acted with scienter in issuing the three public statements which plaintiffs allege to be false and misleading.

IV.

Having concluded in part II that as a matter of law the three statements at issue were not false or misleading, and in part III that as a matter of law with reference to the three public statements that none of the defendants acted with scienter, the court grants the motions of defendant Basic and the individual defendants for summary judgment.⁶³

IT IS SO ORDERED.

/s/ WILLIAM K. THOMAS
U.S. District Senior Judge

FILED
August 3, 1984
United States District Court
Northern District of Ohio
Eastern Division

63. As to all of the individual defendants, the court has concluded that there is no genuine issue of material fact in the evidentiary record as to plaintiffs' claim that one or more of these defendants violated Rule 10b-5. Hence, the court need not consider or rule upon plaintiffs' claim (not asserted in the amended complaint) that some of the individual defendants are secondarily liable as aiders and abettors, see *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), or as control persons under section 20(a) of the 1934 Exchange Act, 15 U.S.C. § 78a, see *Coffey* at 1318.

112a

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION
Civil Action C79-1220

MAX L. LEVINSON, et al.,

Plaintiffs,

—v.—

BASIC, INC., et al.,

Defendants.

ORDER

THOMAS, S.J.

The court having filed its memorandum and order granting defendants' motion for summary judgment, therefore, pursuant to Rule 58, Federal Rules of Civil Procedure,

IT IS ORDERED that the defendants' motion for summary judgment is hereby granted.

IT IS FURTHER ORDERED that plaintiffs' amended complaint is hereby dismissed, with prejudice at plaintiffs' costs.

/s/ WILLIAM K. THOMAS

*United States District
Senior Judge*

FILED

August 6, 1984

United States District Court
Northern District of Ohio
Eastern Division

113a

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DISTRICT
C79-1220

MAX L. LEVINSON, et al.,

Plaintiffs,

—v.—

BASIC INCORPORATED, et al.,

Defendants.

MEMORANDUM AND ORDER

THOMAS, *Senior Judge*

In pressing their motion for class action certification, the plaintiffs have the burden of proving their entitlement to a class action and in demonstrating that each relevant requirement of Rule 23 has been satisfied.

I.

The court will take up first the requirements of Rule 23 (a)(2) and Rule 23(b)(3). The plaintiffs must show that there are questions of law or fact common to the class and that these predominate over any questions affecting only individual members.

Plaintiffs argue that "the complaint spells out a classic 'fraud on the market' causing damage to all investors who sold during the class period." Plaintiffs contend that

in deciding whether common questions of law or fact predominate, the courts have analyzed the "nucleus of operative facts" common to plaintiffs' claims. The com-

mon nucleus of operative facts in the instant case is provided by the three similar public statements issued to the investment community at large, and by Defendants' pattern of conduct.

Plaintiffs say that the common questions which predominate

relate to the truth or falsity of Defendants' public statements, the existence and nature of merger negotiations, the background of the discussion between Basic and other companies, the existence or non-existence of earnings projections, the questions of Defendants' *scienter* and knowledge, the issue of the materiality of Defendants' false and misleading statements, and the impact of those public statements upon the market place and prices of Basic's securities. The common questions overwhelm any individual questions which may arise.

Disputing plaintiffs, defendants argue:

That events are not static during the alleged class period is inherent in plaintiffs' claim that there were continuing negotiations between Basic and C-E during the entire 27-month period. Even assuming *arguendo* (and contrary to fact) that there were negotiations during this period, it would be unreasonable to assume that such alleged negotiations were of the same intensity and at the same point of development throughout the alleged class period.

Defendants continue:

Moreover, just as negotiations are not a static process, the factual basis for any statement concerning the existence or status of negotiations, the circumstances surrounding such statement, the materiality and importance of such statement, the state of mind of the person or entity issuing the statement and the statement's impact, if any, on the market would be subject to change daily, just as general economic and market conditions cause daily fluctuations in stock market activity.

In paragraphs 23, 24, 25, 30, 31, 32 and 33, plaintiffs make specific allegations relating to the three alleged public misrepresentations made by defendants. Plaintiffs allege that each misrepresentation was made with knowledge that it was false and misleading and that defendants made such in an attempt "to quiet the market." Plaintiffs allege that had defendants not made the misrepresentations but instead remained silent, "the market would have continued to respond positively to Basic's prospects."

In paragraphs 27, 29, 35, and 40, plaintiffs allege that the individual plaintiffs relied upon defendants' statements and sold their share of Basic stock in the depressed market created by defendants.

With reference to members of the sought-for class—those who sold Basic stock between October 21, 1977 and December 20, 1978—the allegations of plaintiffs' complaint are sufficient to bring this section 10(b) and Rule 10(b)(5) claim within the so-called "fraud on the market" theory.

Plaintiffs discuss a number of cases which hold that reliance upon misrepresentations will be presumed if plaintiffs prove that the misrepresentations were material, that there existed a causal nexus between the misrepresentations and the market price of the stocks, and that plaintiffs were injured by their reliance upon the open market. See, e.g., *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975); *In re Memorex, Security Cases*, 61 F.R.D. 88 (N.D. Calif. 1973). Most recently in *Ross v. A.H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979), the court, citing to *Blackie*, stated, "In a § 10(b) action, however, reliance is presumed once . . . the material misrepresentation affected the price of stock traded on the open market." *Id.* at 553.

Defendants rely on several cases in which they say that motions for certification "have been denied because the common questions did not predominate over those affecting individual class members." One of these is *Gelman v. Westinghouse Electric Corp.*, 73 F.R.D. 60 (W.D. Penn. 1976), appeal dismissed, 556 F.2d 699 (3rd Cir. 1977). This section 10(b) and Rule 10(b)(5) class action case, brought against Westinghouse Electric Corporation and certain of its officers

and agents, arose out of events "leading up to and surrounding Westinghouse's sale of its 'Major Appliance Division (MAD)' to White Consolidated Industries (WCI) in December of 1974." Judge Teitelbaum, United States District Court for the Western District of Pennsylvania, found the requirements of Rule 23(b)(3) were not satisfied and denied plaintiffs' motions for class certification. The court concluded, as one basis for its decision:

[I]t would seem clear that the issue of materiality relevant to any purported class member's nondisclosure claim is highly individualized (if not wholly individual to him), because it involves only those continuously changing facts and corporate judgments pertaining at or near the date of his sale.

Recognizing that *Blackie v. Barrack* "approv[ed] the district court certification of a (b)(3) plaintiff class in circumstances bearing a resemblance to those presently before me," Judge Teitelbaum stated:

Insofar as *Blackie* can be read as an expression of the ninth circuit's preference for a different result, I simply and respectfully disagree.

Defendants rely upon *J.H. Cohn & Co. v. American Appraisal Assocs., Inc.*, 628 F.2d 994 (7th Cir. 1980) as further support for their argument that individual rather than common questions predominate. Defendants maintain that in *Cohn* "[t]he Court affirmed the denial of certification because questions common to the class did not predominate. . . ." Defendants' characterization of the case omits a salient parameter. Plaintiffs sought mandamus relief from the district court's denial of class certification. The court recognized that in an action for mandamus its role was limited to determining whether "the district court [usurped] its judicial power or indisputably abuse[d] its discretion in ruling not to certify the class." *Id.* at 998. Under the circumstances presented by the case before it, the court could not conclude that the district

court "arbitrarily refused to certify the class." Rather than affirming the denial of certification, as defendants here assert, the court refused to grant mandamus relief.

Defendants attempt to distinguish *Blackie v. Barrack*, *supra*, by characterizing it as an omission or non-disclosure case. They rely upon *Kiernan v. Homeland, Inc.*, 611 F.2d 785 (9th Cir. 1980), wherein the court cited *Blackie* as holding that "a purchaser of stock in the open market who claims injury because deceptive omissions from publicly issued financial reports created an inflated market price need not show personal reliance." 611 F.2d at 789. The *Kiernan* court in discussing in a footnote the extension of *Affiliated Ute Citizens v. United States*, 408 U.S. 128 (1972), to affirmative misrepresentation cases failed to cite *Blackie* and implied that the ninth circuit had not decided the issue. 611 F.2d at 788, n.4.

The ninth circuit's position simply is not clear to this court. Certainly in *Kiernan* there was no express limiting of *Blackie*, as defendants suggest, and no where can this court find support, except in n.4 of the opinion, for defendants' statement that "the Ninth Circuit explained that *Blackie* did not decide whether the presumption of reliance could be extended to cases where affirmative misrepresentations played an important role." In *Arthur Young & Co. v. United States District Court*, 549 F.2d 686 (9th Cir. 1977), the court, citing to *Blackie*, indicated the opposite, "The Circuit has also expanded the *Affiliated Ute* equation of materiality and causation to include those cases involving misrepresentations that inflate the price of stock traded on the open market." *Id.* at 695. The ninth circuit ruled that the district court's reservation of the reliance issue for a separate trial did not justify mandamus relief.

In *Imperial Supply Co., Inc. v. Northern Ohio Bank*, C75-180, this court on December 13, 1976 certified the case as a class action. In doing so this court cited *Blackie v. Barrack* with approval. In part this court stated:

Moreover, in applying the market impact theory of inflation of market price due to the various disseminated

corporate documents, common questions of law and fact arise concerning the period of the impact of one or more of such alleged misrepresentations on the market price of the stock. Necessarily any misrepresentation that remained "alive" throughout the life of the bank would present a question of fact common to all members of the class irrespective of when a member purchased his stock. Yet as *Blackie* holds, proof of any misrepresentation that did not remain "alive" throughout the life of the bank would, nevertheless, be relevant to establishment of defendants' culpability.

This court continues to recognize the validity of the "fraud on the market" theory. It is a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of Rule 23. To require proof of individualized reliance in every 10(b)(5) misrepresentation action would bar such actions from proceeding as class suits because the individual questions would far outnumber and overwhelm the common ones. If every reliance issue must be treated as an individual issue, even bifurcation of these individual issues from the common questions would prove unmanageable and undermine the use of class actions.

Defendants argue that individual questions predominate over common questions because "no presumption of reliance may be utilized" to overcome the need for "specific individual proof as to reasons for each sale." Defendants use the allegations of individual reliance found in plaintiffs' complaint to support their argument that individual reliance need be shown. However, as Judge Spencer Williams in *Memorex* noted, at p.100, in an action brought by a single plaintiff, "the application of a strict common law reliance requirement is clearly justified." It is only in the context of a class action that a different standard of reliance, one which Judge Spencer Williams termed an "objective standard," is permitted. Thus a plaintiff, not knowing whether the action will ever be certified as a class, must allege the requisite individual reliance in his

complaint. It is in considering the class certification motion that the court must focus on the allegations of the complaint to see whether the "fraud on the market" theory is available to the class plaintiffs. Allegations of individual reliance, then, should not bar class certification.

These are some of the common questions, mixed as to law and fact, which are present:

- (1) Are one or more of the three public statements false or misleading?
- (2) Was a particular statement under consideration knowingly false or misleading or made with reckless disregard for the truth?
- (3) Was a particular statement material, that is, was it one that a reasonably prudent investor was likely to consider important in making an investment decision?

Since with reference to each of the public statements and the impact of a particular statement upon the open market these common questions predominate over individual questions, it is concluded that (a)(2) and (b)(3) are both satisfied.

II.

Pursuant to Rule 23(a)(1) the plaintiffs must show that "the class is so numerous that joinder of all members is impracticable."

Plaintiffs submit the Cross affidavit, which in effect supercedes the Van Deusen affidavit. It states that 1,990,800 shares of common stock were traded for the period October 21, 1977 through December 20, 1978, and for the same period, 33,940 shares of preferred stock were traded. Adopting this time period as the class period, plaintiffs urge that the number of sellers during this class period may be fixed at 2,400 persons based on the assumption that each trade involved 400 shares.

Plaintiffs say that courts have consistently held that "numerosity may be inferred from trading volume," citing, *Gold v. DLC, Inc.*, 399 F.Supp. 1123, 1129 (S.D.N.Y. 1973), in

which case Judge Frankel assumed individual purchases of 100 shares.

Another judge of the Southern District of New York, Judge Werker, used the figure of 200 shares as the average number of shares purchased by an individual stockholder in estimating the size of a purported class of shareholders. *Waldman v. Electro Space Corp.*, 443 F.Supp. 40, 42, n.3 (S.D.N.Y. 1977). This resulted in a class of 15,200 shareholders.

Smaller classes have been recognized by several courts in the Northern District of Ohio. These cases cited by the plaintiffs, permitted classes of 1,200 and 600. In *Atleson v. Ball, Burge & Crouse*, C72-1186 (N.D. Ohio), decided February 15, 1974, this court found that it would be impracticable to permit joinder of 24 debenture purchasers and that this number, therefore, satisfied the numerosity requirement of Rule 23.

Even if the court were to use the defendants' calculations, at pp. 14-15 of its brief, arguing that "the class would consist of fewer than 45 individuals," the size of the class would not be too small to warrant class action certification.

Defendants' calculation of a limit of 45 stockholders who might have been affected by each public statement is based on the assumption that "the so-called artificially depressed market prices which allegedly follow the issuance of [each public statement] . . . did not have a duration of more than one week." Plaintiffs respond:

As to defendants' remaining claim that those who sold more than one week after defendants' public statements are too "remote" to recover, the cases show that classes are consistently certified on behalf of persons who engage in security transactions over far longer periods than that alleged here. [Citations omitted.] As those cases demonstrate, the class should encompass the period between defendants' false public statements and disclosure of the true facts. There is simply no basis for the defendants' claim, and in any event, defendants' argument goes to the merits of class members' claims and is inappropriate on a class motion.

In support, plaintiffs cite *Weiss v. Drew Nat. Corp.*, 71 F.R.D. 429 (S.D.N.Y. 1976). Establishing a four-year class period, the court rejected defendant's contention that the duration of the alleged conspiracy and the numerosity of the written statements defeated the propriety of class certification. The court held:

Rather, as a growing number of courts have recognized, where plaintiff claims a continuing course of conduct and points to specific and identified documents which are alleged to contain interrelated and cumulative misrepresentations, class certification is proper. See, e.g., *Blackie v. Barrack*, 524 F.2d 891, 902 (9th Cir. 1975), [other citations omitted].

Id. at 430.

Plaintiffs' amended complaint similarly alleges "interrelated and cumulative misrepresentations." Thus, referring to the *Cleveland Plain Dealer* article of October 21, 1977 and its statement that "no negotiations were underway with any company for a merger," the complaint alleges in paragraph 24 that

as averred in paragraph 20(a) hereof, defendants knew that Basic was actively engaged in a continuing negotiation with Combustion with respect to an acquisition of Basic by Combustion.

In paragraph 25, plaintiffs allege:

[T]he market price of Basic's Common and Preference Shares was artificially depressed as follows:

(a) If defendants' statement of October 21, 1977, had included the disclosure of the existence of the continuing negotiations between Basic and Combustion which was necessary to make that statement not misleading, the market price of Basic's securities would have increased to reflect the potential benefit to shareholders of Basic of such an acquisition[.]

After citing the statements of September 26, 1978 and November 6, 1978 that there were no present or pending company developments, in paragraph 32, plaintiffs state:

Defendants issued these statements with the intention of calming the market for Basic's securities in maintaining the market price of such securities at an artificially depressed level, notwithstanding their knowledge, as averred in paragraph 20 hereof, of (a) the continuing negotiations with Combustion for an acquisition of Basic at a price far in excess of current market prices and (b) the developments in Basic's business which had resulted in dramatically increased sales and earnings for 1978 and subsequent years. Defendants knew that the negotiations with Combustion were nearing fruition. Defendants knew that if such facts were disclosed to the public, the market price of Basic's securities would increase substantially. Defendants knew that investors would rely upon their disclaimers of any present or pending company development making their investment decisions. Indeed their statements were issued with the intention of influencing the market activity in and the price of Basic's securities. Accordingly, defendants had a duty as of the September 26, 1978, statement averred in paragraph 30 hereof to disclose the facts known to them, as averred in paragraph 20 hereof, in order to make that disclaimer not misleading. That duty to disclose continued with respect to the November 6, 1978, disclaimer averred in paragraph 31 hereof.

Clearly these allegations describe continuing negotiations between C-E and Basic for Combustion's acquisition of or merger with Basic.

Because in considering this Rule 23 motion it is this court's understanding of the applicable law that it may not take evidence to resolve the disputed truth of plaintiffs' allegations, the court must assume the truth of these allegations. Whether the public statements were true or false and, if false or misleading, whether there was a duty to disclose additional

facts to make the statements not misleading, are common questions that predominate over any individual questions in this action. Under the allegations, it is evident that neither Basic nor Combustion made a disclosure. Since no corrective or curative statement was made, assuming a duty to make such a statement, it is reasonable to conclude that the effect of the statement of October 21, 1978 remained in effect on September 26, 1978 and was reinforced by the public statements of September 26, 1978 and November 26, 1978.

Assuming the truth of the factual allegations, the court also must assume, as alleged, that the statements artificially depressed the market and that this dampening effect continued until the announcement of C-E's tender offer on December 20, 1978.

The court concludes, however, that if the undisputed market record of the daily price and volume activity of Basic stock should contradict or rebut this court's assumption based on the complaint that Basic's stock prices were artificially depressed as a result of the public statements, then the court, in passing on this motion, would not be bound to accept as true such crucial assumptions. It is for this reason that the court has requested production at today's hearing of the relevant history of trading activity in Basic's stocks during the indicated period.

Since pursuant to Rule 23(c)(1) any order of class certification will be made "conditional," it "may be altered or amended before the decision on the merits," as to the issue of certification and any subsumed issue such as the proper length of the class period should the circumstances warrant.

Defendants point out that "even if the so-called artificially depressed market conditions are assumed to have endured between the statements, these shareholders [purchasers after the October 1977 statement who sold their shares before the September 26, 1978 statement] would not be damaged since they would have bought and sold at the alleged 'depressed' price."

Opposing this argument, plaintiffs cite *In re LTV Securities Litigation*, 88 F.R.D. 134, 148 (N.D. Texas 1980):

Defendants . . . urge that a person who both bought and sold, as a matter of law, has suffered no injury by any inflated market price. This argument has, because of its simplicity, immediate appeal. But this argument fails to deal with the circumstances that one who has both bought and sold in a tainted market may nonetheless have suffered an injury.

88 F.R.D. at 148. That statement is made in the context of the court's overall consideration of class certification. Treating the similar issue here as a discrete issue of class exclusion, defendants' objection at this point seems unassailable. This group of shareholders is excluded from any class subject to the court's continuing authority to include this group in the class should the facts on the merits show that damage was actually suffered by such selling shareholders.

Viewed overall, it is determined that the plaintiffs have satisfied the numerosity requirement of Rule 23.

III.

Defendants argue that the class certification motion should be denied because plaintiffs do not satisfy the typicality requirement of Rule 23(a)(3). Defendants in essence, are attacking plaintiffs' allegations of reliance upon the alleged misrepresentations. Plaintiffs respond that arguments as to the plaintiffs' reliance go to the merits of the claim and therefore are not properly considered on a class certification motion.

It is necessary to look at each plaintiff individually to determine whether there exist unique defenses as to that plaintiff which would make his claims not typical. Defendants argue that plaintiff Newman, "as a former registered representative with several brokerage firms, is a sophisticated investor." They argue further that he did not sell the first group of stocks until 50 days after the October 21 statement and the bulk of his shares until January 1978. Defendants state, "These facts, including the particular defenses they present, demonstrate that Newman is not typical and could not represent a class of shareholders." Defendants appear to be arguing (1) that a sophisticated investor would not have relied on the statements

and (2) that Newman's delay in selling indicates that he sold for reasons other than defendants' statements.

Mere allegations that plaintiff was a sophisticated investor without a showing that the sophistication renders plaintiff's claim atypical, *i.e.*, that plaintiff sold because of factors other than the statements, will not defeat plaintiff's representative status. See *Koenig v. Smith*, 88 F.R.D. 604, 607 (E.D.N.Y. 1980); *Feder v. Harrington*, 52 F.R.D. 178, 183-84 (S.D.N.Y. 1970).

The issue raised by plaintiff Newman's failure to sell until 50 days after the making of the statement on which he allegedly relied has been resolved by this court's decision under part II. Plaintiff Newman may prosecute his claim and serve as a class representative because the requisite nexus of statement-market impact is sufficiently alleged to have continued through his selling period.

Defendants' allegations regarding plaintiff Zuckerman raise serious questions as to the typicality of his claims. Zuckerman claims to have sold his shares of Basic because of the October 21, 1977 statement. However, he allegedly purchased 1,400 shares of the stock between October 21 and November 11. During the same period he allegedly sold 1,000 shares; the remaining shares were sold over a period of several months.

Defendants describe Zuckerman as a "speculator" and allege that his broker (Seidman) had contact with Basic officials and that he "was aware of rumors concerning a possible takeover of Basic." According to defendants, Zuckerman testified in deposition that he thought he purchased Basic stock after October 21 for a quick sale. These allegations lead this court to conclude that plaintiff Zuckerman will be subject to unique defenses in a manner similar to certain plaintiffs in *Kline v. Wolf*, 88 F.R.D. 696 (S.D.N.Y. 1981) and *Model Associates v. U.S. Steel Corporation*, 88 F.R.D. 338 (S.D. Ohio 1980). These defenses go beyond those to which the rest of the plaintiff class will be subject and render plaintiff Zuckerman's claims atypical. He may not, then, serve as a class representative.

Moreover, this court has serious doubts as to whether a plaintiff who purchased stock *after* having read and relied

upon a statement which he asserts prompted him to then *sell* the stock can prove that any loss sustained resulted from the misrepresentations rather than from his own speculation. That issue is, however, left for the trial on the merits of his individual claim.

Finally, plaintiff Levinson has claimed reliance upon all three statements. Defendants attack his credibility, alleging that he first testified to relying only upon the November 1978 statement but later remembered having seen and relied upon all of the statements. Defendants contend that Levinson "could not have received the report containing the November 1978 statement until well after he had sold his Basic shares." Plaintiff disagrees with that assertion.

Clearly this is not the time for the adjudication of plaintiff Levinson's credibility. This is not a situation like that in *Kline v. Hoff* where the court had before it strong evidence disputing plaintiff's adequacy as a class representative. The issue of plaintiff's credibility must be left to the trial on the merits where defendants certainly may rebut the presumption of Levinson's reliance. Defendants have not shown the court that there exist unique defenses which would render Levinson's claims atypical.

Plaintiff Levinson may represent class members who sold after the October 1977 statement. He may also represent those selling after the 1978 statements, the period of time during which he actually sold.

IV.

Pursuant to Rule 23(a)(4), the defendants also challenge the adequacy of plaintiffs Newman and Levinson to protect the interests of the class. Viewing the relevant evidence in its totality, it is concluded that they have sufficient financial resources to meet the costs of a (c)(2) notice and other likely suit costs. Also their counsel have demonstrated their competence and ability to fairly and fully represent class members. It is determined that Newman and Levinson will "fairly and adequately protect the interests of the class."

Finally, on the entire record, it is concluded that a "class action is superior to other available methods for the fair and efficient adjudication of the controversy" as required by Rule 23(b)(3). The motion for class action certification is granted.

IT IS SO ORDERED.

WILLIAM K. THOMAS
U.S. District Senior Judge

FILED
December 10, 1981
United States District Court
Northern District of Ohio
Eastern Division

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION
C79-1220

MAX L. LEVINSON, et al.,

Plaintiffs,

—v.—

BASIC INC., et al.,

Defendants.

MEMORANDUM AND ORDER

THOMAS, Senior Judge

Defendants have moved for reconsideration of this court's memorandum and order of December 10, 1981 granting plaintiffs' motion for class certification. Defendants move, in the alternative, for certification of an interlocutory appeal. Defendants also seek modification of the December 10 order on two grounds: (1) the order should have conformed to the discovery to date; and (2) the court should have eliminated from the certified class those persons who sold on December 20, 1978.

I.

A.

The primary issue raised by defendants is one which was argued extensively by the parties in their briefs on the class certification motion: whether individual reliance by plaintiffs must be shown in a case involving allegations of misrepresentations effecting a fraud on the market. In its December 10 order

this court referred to its class certification order in *Imperial Supply Co., Inc. v. Northern Ohio Bank*, C75-180 (filed December 13, 1976), wherein the court adopted the position of *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975). This court then stated that it "continues to recognize the validity of the 'fraud on the market' theory," finding that theory to be "a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of Rule 23." This court reasoned that requiring a showing of individual reliance and not permitting the utilization of the fraud on the market theory would bar class actions in Rule 10b-5 misrepresentation cases "because the individual questions would far out number and overwhelm the common ones."

This court agrees with Judge Werker's statement in *Tucker v. Arthur Andersen & Co.*, 67 F.R.D. 468, 480 (S.D.N.Y. 1975):

Justification for the use of a presumption of reliance in open market transactions need not, and indeed should not, be premised on the bringing of the 10b-5 suit as a class action, for this would raise a serious question of modification of substantive rights in violation of the Rules Enabling Act, 28 U.S.C. § 2072 (1970).

Justification for the use of a presumption of reliance in open market transactions has been well explained by Chief Judge Northrop in *Lewis v. Capital Mtg. Investments*, 78 F.R.D. 295 (D.Md. 1977):

If certain investors rely on the misrepresentations and thereby inflate the market price of the stock, other investors who rely merely on the integrity of the market are injured when they purchase the stock at the inflated price. Thus, the "causal link" between the misrepresentations and the investor's injury is not his own subjective reliance on the misrepresentations, but rather the reliance of other investors on the misrepresentations, which thereby inflates the market price. *Blackie v. Barrack*, *supra* at 907. See, *In re Memorex Security Cases*, *supra* at 101.

Id. at 309. Judge Northrup continued:

It would be impractical to compel plaintiff to prove actual reliance by a number of investors sufficient to inflate the market price of the stock. *Reliance and Private 10b-5 Actions* [88 Harv. L. Rev. 584]. Rather, if plaintiff establishes materiality by demonstrating that the misrepresentations would influence a reasonable investor, it is reasonable to presume that a number of investors relied on the misrepresentations and thereby inflated the market price.

Id.

Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *In re Memorex Security Cases*, 61 F.R.D. 88 (N.D. Calif. 1973), *Tucker*, and *Lewis*, it is true, are all cases brought by purchasers. The present action is brought by sellers. The defendants seek to distinguish purchasers' 10b-5 suits from sellers' 10b-5 suits. In the former, they say, "Defendants . . . are charged with acting in their own self interest so as to benefit the corporation and its management." In the latter, they say "Defendants . . . are charged with acting against their own interests and those of the corporation and its management." Assuming that this is an accurate summary of charges made by plaintiffs against defendants in the two classes of 10b-5 suits, reference to defendants' motivation would be more relevant in considering the element of scienter which plaintiffs are required to prove. But such summary should not preclude the plaintiffs from attempting to prove the 10b-5 violations they allege. As sellers of Basic shares, they say

defendant Basic made false and/or misleading statements that caused "the market price of its stock to fall and to be maintained at an" artificially low level, and that induced plaintiffs to sell at that low level rather than hold on to their stock and take advantage of the higher price offered by CEBAS.

In this sellers' 10b-5 case, the use of a presumption of reliance in open market transactions is justified. If, as plaintiffs allege, the statements were issued by the defendants to quiet the market, even though the statements were false or misleading, and if the plaintiffs can establish materiality of those statements by demonstrating that the misrepresentation would influence a reasonable investor to sell his Basic shares, it is reasonable to presume that a number of Basic investors relied on the misrepresentations, sold their stock, and thereby depressed the open market price of the shares. If these allegations are proved, causation-in-fact between the issuance of false and misleading statements and the sell transactions, with resulting reduction in stock price, has been established. Put another way, reliance has been established since "the concepts of reliance and causation have often been used interchangeably in the context of Rule 10b-5 cases." *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92 (2d Cir. 1981), at n.6.

B.

Defendants argue:

Insofar as the present motion seeks reconsideration, it will be shown that, under *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977), a fraud on the market/presumption of reliance theory may not be invoked to establish transaction causation. *Fridrich* makes clear that plaintiffs and the class must establish actual reliance upon the statements in issue.

This court has stated the holding of *Fridrich* as follows:

[A] defendant who trades securities in an open and impersonal market without disclosure of material inside information but who does not purchase any shares of stock from a complaining plaintiff and whose inside trading does not affect the plaintiff's trading decision,

may not be held liable under § 10(b) for the plaintiff's claimed market losses.

Levinson v. Basic Inc., C79-1220 (memorandum and order overruling motion for reconsideration, filed October 14, 1980), slip op. at 4. In *Fridrich* the court defined the violation of Rule 10b-5 in a non-disclosure setting as being the act of trading by the person with inside information. Trading with inside information can impair the integrity of the market by putting the market participants in unequal positions, the insider versus the outsider. Given the facts of *Fridrich* where it was determined that the defendants' trading had no impact upon the value of the stock, "did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decisions," defendants' acts could not be said to be causally connected to plaintiffs' losses. *Id.* at 318.

In this case, the violation of Rule 10b-5 which is pressed, is the purposeful or reckless dissemination of misleading corporate information by the defendants. As the court stated in its October 14, 1980 memorandum and order, "[T]he corporate disclosures omit material information that predictably may alter market expectations and influence trading decisions." The court, with this statement, distinguished the instant case from *Fridrich*. Since the purpose of Rule 10b-5 is the protection of the integrity of the securities market, misrepresentations, which are likely to have an effect on the market, are to be treated differently from pure nondisclosure, which is not likely to have an effect on the market.¹

The *Fridrich* court held: "[T]he defendants' act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the

1. In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), the Court permitted a presumption of reliance in a nondisclosure case where because of the relationship between the parties, the defendants had an obligation to disclose the material facts. The Court stated, "This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." *Id.* at 154.

insider." *Id.* at 318-19. It was "undisputed that defendants did not purchase any shares of stock from plaintiffs, and that defendants' acts of trading in no way affected plaintiffs' decision to sell." There was lack of evidence of any market response to defendants' violations, *id.* at 320, n.27, and lack of evidence that defendants' conduct in any way induced plaintiffs to sell.

This court ruled on December 10 that transaction causation could be established by the following: proof of a material misrepresentation which affected the market price of the stocks with a resulting injury to the plaintiffs. The nexus missing in *Fridrich* is required here, *i.e.*, the impact of the misrepresentation on the market. The *Fridrich* court specifically excluded from its consideration the open market transaction where a causal connection could be established between the insider trading and an effect on the market inducing plaintiff to act. *Id.* at 320, n.27. ("We specifically do not reach the question of availability of the remedy to open market situations where the insider trading with resultant price changes has in fact induced the plaintiffs to buy or sell to their injury.") This court thus cannot agree with defendants that *Fridrich* precludes the application of the fraud on the market theory to the facts of this case. Instead it is believed that *Fridrich* is limited to situations where there has been insider trading with no demonstrated causal nexus between that trading and the plaintiff's injury.

Defendants argue that in *Wilson v. Comtech TeleCommunications Corp.*, 648 F.2d 88 (2d Cir. 1981), the Second Circuit refused "to extend the *Affiliated Ute* rationale to presume reliance upon alleged false and misleading statements by persons trading on an open market." Wilson's principal 10b-5 claims involved knowledge gained at analyst briefings with Comtech executives.² The district court dismissed the case after trial because plaintiff had failed to demonstrate transaction causation. In affirming the dismissal, the court stated, in part:

2. In a further claim, Wilson claimed that appellees engaged in unlawful insider trading. That claim is discussed in connection with *Shapiro v. Merrill Lynch*, 495 F.2d 228 (2d Cir. 1974). But in this open market aspect of the case, there is no discussion of presumed reliance.

To be sure, under *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972), causation in fact may be established in the case of a nondisclosure if the information withheld is found to be material. But as Judge Waterman stated in referring to *Affiliated Ute*:

[T]he Court, rather than abolishing reliance as a prerequisite to recovery, was recognizing the frequent difficulty in *proving*, as a practical matter, that the alleged misrepresentation, allegedly relied upon, caused the injury . . . Unlike instances of affirmative misrepresentation where it can be demonstrated that the injured party relied upon affirmative statements, in instances of total non-disclosure, as in *Affiliated Ute*, it is of course impossible to demonstrate reliance . . . What is important is to understand the rationale for a presumption of causation in fact in cases like *Affiliated Ute*, in which no positive statements exist: reliance as a practical matter is impossible to prove . . . The situation here does not present that problem.

648 F.2d at 93. In the oral setting out of which plaintiff's principal claims arose, the court is saying that he must show the presumed reliance of *Affiliated Ute* or prove affirmative misrepresentation. It is in that context that the court made the foregoing statement with reference to presumed reliance. But since there is no discussion of presumed reliance in connection with an open market transaction, *Wilson* is not interpreted as ruling out the use of presumed reliance in an open market setting.

In *Panzirer v. Wolf*, [Current Binder] Fed.Sec.L.Rep. (CCH) ¶ 98,333 (2d Cir. Oct. 28, 1981), the Second Circuit reversed the trial court which had granted summary judgment for the defendant. Plaintiff allegedly purchased Allied stock in reliance upon favorable articles in *The Wall Street Journal*. Plaintiff alleged reliance upon the integrity of the market, i.e., because of Allied's misleading annual report, the stock ana-

lysts interviewed by the *Journal* reported favorably on the company, the *Journal* wrote about it and plaintiff responded. The court noted that the trial court had held that plaintiff " 'primarily' relied on *The Wall Street Journal* . . . and that plaintiff placed only secondary reliance on the integrity of the market." Finding no basis for distinguishing between primary and secondary reliance, the court of appeals ruled that

if Plaintiff can link her injury to defendant's fraud by showing the fraud was a "substantial" or "significant contributing cause," plaintiff has shown sufficient reliance to support her claim. *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92 (2d Cir. 1981).

The court explained why the Second Circuit and other circuits have adopted presumed reliance in open market transactions:

Proving reliance is necessarily difficult where the fraud has affected the market and damaged the plaintiff only through its effect on the market. Relying on *Affiliated Ute*, this and other circuits do not require direct reliance where the fraud affects the market, on the ground that an investor relies generally on the supposition that the market price is validly set and that no unsuspected fraud has affected the price. See *Ross v. A.H. Robins Co.*, 607 F.2d 545, 554 (2d Cir. 1979), *cert. denied*, 429 U.S. 816 (1976). As in *Affiliated Ute*, *Blackie* held that the materiality of a fraud creates a presumption of reliance through its presumed effect on the market. See also Note, *The Reliance Requirement in Private Actions under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 589 (1975).

Ross v. A. H. Robins Co., 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 429 U.S. 816 (1976), (quoted at p.3 of this court's memorandum and order of December 10, 1981), and *Blackie v. Barrack*, *supra*, are cited by the court to support its statement that "this and other circuits do not require direct reliance where the fraud affects the market." But then the court carries the second circuit beyond *A.H. Robins* and beyond *Blackie*. It

justifies its holding by saying that "[i]t is no more than an extension of *Blackie*."

Zelda Panzirer did not rely on the integrity of the market price because she did not rely on price, but she did rely on the integrity of the market in producing the information reported in *The Wall Street Journal*. Just as a material misrepresentation or omission is presumed to affect the price of the stock, so it should be presumed to affect the information "heard on the street" which led Zelda Panzirer to make her losing investment.

In view of these clear expressions of Judge Lumbard writing for the *Panzirer* panel, the court does not accept defendants' assumption or their statement:

The refusal of the Second Circuit to extend the *Affiliated Ute* rationale to presume reliance upon alleged false and misleading statements by persons trading on an open market is also shown by *Panzirer v. Wolf*.³

This court has concluded that a presumption of reliance results if it is shown that statements materially misrepresent or mislead and that such statements depressed market prices. This would constitute a fraud on the market. But such a presumption is rebuttable. Both with reference to a plaintiff and any class member defendants may show that such statements, even if they materially misrepresented or mislead, were not a "substantial" or significant contributing cause of the plaintiff's or class member's sale of their shares.⁴

3. The Second Circuit affirmance of the lower court's denial of class certification is of no relevance here. It was solely on the ground that "plaintiff's lack of credibility made her an inadequate class representative under Fed.R.Civ.P. 23(A)(4)."

4. In *Rifkin v. Crow*, 574 F.2d 256 (5th Cir. 1978), the court articulated but did not adopt, absent "full development of the facts," the fraud on the market theory of action. The court explained:

A defendant can rebut this presumption of reliance in two ways: by proving that an insufficient number of traders relied to inflate the

Defendants have offered no new facts or law which would alter this court's order certifying the class. The order is reaffirmed.

II.

Defendants argue that "the court erred in ignoring the facts developed during discovery in granting class certification." Defendants have not brought to the court's attention specific facts which it should have considered but did not. It should be apparent from the court's ruling on defendant Zuckerman's failure to meet the typicality requirement that the court considered evidence beyond the face of the complaint. The court simply determined that it was not appropriate to turn a class certification hearing into a hearing on the merits or to reach conclusions on credibility issues.

III.

Defendants argue that "persons who sold on December 20, 1978 should not be certified as members of the class." Trading in Basic shares was suspended from December 18 to December 20. Given this notice to shareholders, the court agrees with defendants that the class period should terminate at the close of the market on Friday, December 15, 1978.

IV.

Finally, defendants move for certification of an interlocutory appeal. The governing statute, 28 U.S.C. § 1292(b), permits certification of an otherwise unappealable order when the district court determines that its order (1) "involves a controlling question of law," (2) "as to which there is substantial ground for difference of opinion," and (3) "an immediate

stock's price, or by proving that the plaintiff purchased despite knowledge of the misrepresentation or omission or that he would have purchased had he known of it.

Id. at 263.

appeal may materially advance the ultimate termination of the litigation."

Defendants, in short, contend that

since, if class certification were denied, the ultimate termination of this action would be materially advanced, the impact of *Fridrich* upon a motion for certification presents a controlling question of law appropriate for expedited interlocutory review under 29 U.S.C. § 1392(b).

The question they ask to be certified is:

May class action plaintiffs alleging open market sales at prices allegedly depressed because of false and misleading statements utilize a presumption of reliance to establish transaction causation or does *Fridrich* require a showing that their affirmative reliance on the statements induced their trading activity?

Opposing appellate certification of this case, the plaintiffs contend that defendants do not wish to appeal the court's class certification as such but rather the subissue related to proof of individual reliance and the fraud on the market theory.

Should the court of appeals decide that *Fridrich* requires that every plaintiff (individual or class member) needs to show that affirmative reliance on false and misleading statements induced their trading activity, then this court's class action certification would be overturned. But even if the court of appeals should conclude that *Fridrich* does not so require, the court of appeals would still face the question of whether

class action plaintiffs alleging open market sales at prices allegedly depressed because of false and misleading statements [can] utilize a presumption of reliance to establish transaction causation.

This question, undecided in this circuit, is a controlling question.

Defendants argue that they "will be put to enormous burden and expense in a potentially futile exercise" if the Sixth Circuit on appeal after trial finds the class "improperly certified." It is

undisputable that at the very heart of the class certification issue is a substantive securities law question. If individual reliance need be proved by all plaintiffs, class members and the named ones, the individual questions of fact would very likely predominate over the common questions and in all probability bar class certification.

There is, then, a controlling question of law on which the Sixth Circuit has not ruled. While there exist precedents in the rulings of other circuits for this court's position, the court cannot say that there is no "substantial ground for difference of opinion."

Finally, defendants are correct that the time and money to be spent in trying this suit as a class action will have been expended unnecessarily if the Sixth Circuit were to conclude after trial that the substantive requirement of individual reliance need be shown in this case. An appeal of the issue at this point will avoid the unnecessary expenditure of time and resources and will "materially advance the ultimate termination of the litigation" by defining the burdens of proof existing as to all parties.

The importance of proceeding with care in Rule 10b-5 class actions was noted by Justice Rehnquist in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), as it was by Judge Friendly in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (Friendly, J., concurring). The court has the responsibility of balancing the interests of injured participants in the market against the potential of use of the class action device to coerce settlement. Where, as here, a court's order affects a substantive element of a Rule 10b-5 cause of action, it is only fair to permit the parties affected to protect their interests by asserting their appeal rights at an early stage.

For the above stated reasons, defendants' motion to reconsider is denied, the class period previously defined is modified, and defendants' motion for certification of an interlocutory appeal is granted. The court orders certification of the following questions:

1. Under *Fridrich*, must each member of the class certified in this case demonstrate that his individual reliance on the defendants' statements induced him to sell?
 2. Stated more broadly, in a 10b-5 action where the class plaintiffs allege open market sales at prices allegedly depressed by defendants' misrepresentations, may reliance be presumed to establish transaction causation for the stock sale of each class member?

IT IS SO ORDERED.

/s/ WILLIAM K. THOMAS
U.S. District Senior Judge

FILED
 February 17, 1982
 United States District Court
 Northern District of Ohio
 Eastern District

UNITED STATES COURT OF APPEALS
 FOR THE SIXTH CIRCUIT

No. 82-8331

MAX L. LEVINSON, KARL ZUCKERMAN, INDIVIDUALLY AND
 AS TRUSTEE UNDER THE KARL ZUCKERMAN REVOCABLE
 TRUST, AND RONALD M. NEWMAN,
Plaintiffs-Respondents,

—v.—

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL
 EELLS, JR., JOHN A. GELBACH, HARLEY C. LEE,
 MATHEW J. LUDWIG, MAX MULLER, H. CHAPMAN ROSE,
 EDMUND Q. SYLVESTER, JOHN C. WILSON, JR.,
Defendants-Petitioners.

Before:

BROWN, MARTIN and JONES, *Circuit Judges*

ORDER

Upon receipt of the defendants' petition to take an interlocutory appeal to this Court pursuant to 28 U.S.C. §1292(b) and Rule 5, Federal Rules of Appellant Procedure,

And upon consideration of the memoranda filed in support of and in opposition to such an appeal,

It is ORDERED that said motion be and it hereby is denied.

ENTERED BY ORDER OF THE COURT

/s/ JOHN P. HEHMAN

FILED
 April 19, 1982
 United States Court of
 Appeals for the Sixth Circuit

Clerk

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

Nos. 84-3730

84-3775

84-3776

MAX L. LEVINSON; KARL ZUCKERMAN;
RONALD M. NEWMAN,
Plaintiffs-Appellants (84-3730),
Plaintiffs-Appellees (84-3775/76),

—v.—

BASIC INCORPORATED,
Defendant-Appellee (84-3730),
Defendant-Appellant (84-3775),
ANTHONY M. CAITO, et al.,
Defendants-Appellees (84-3730),
Defendants-Appellants (84-3776).

Before:

MARTIN, JONES and WELLFORD, *Circuit Judges.*

JUDGMENT

ON APPEAL from the United States District Court for the
Northern District of Ohio.

THIS CAUSE came on to be heard on the record from the
said District Court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and
adjudged by this court that the judgment of the said District

Court in this case be and the same is hereby affirmed in part,
reversed in part, and the case is remanded for further proceed-
ings consistent with this opinion.

Each party is to bear its own costs on appeal.

ENTERED BY ORDER OF THE COURT

/s/ JOHN P. HEHMAN

Clerk

FILED

March 27, 1986

United States Court of
Appeals for the Sixth Circuit

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 84-3730

MAX L. LEVINSON, ET AL.,
Plaintiffs-Appellants,

—v.—

BASIC, INC., ET AL.,
Defendants-Appellees.

Before:

MARTIN, JONES, and WELLFORD, *Circuit Judges*

ORDER

The Court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this Court, and no judge of this Court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

/s/ JOHN P. HEHMAN

John P. Hehman, *Clerk*

FILED

June 19, 1986

United States Court of
Appeals for the Sixth Circuit

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 84-3730

MAX L. LEVINSON, ET AL.,
Plaintiffs-Appellants,

—v.—

BASIC, INC., ET AL.,
Defendants-Appellees.

ORDER

Upon consideration, it is ORDERED that the June 19, 1986 order denying the petition for rehearing en banc in this case be amended as follows. The following is to be appended to that order:

“WELLFORD, J., concurring in the denial of the petition for rehearing:

I concur in the denial of the defendants' petition for rehearing, but I write separately to emphasize two points raised in the petition to rehear dealing with the materiality issue.

First, I do not read the court's opinion to establish, as the defendants have argued, 'a conclusive presumption of materiality for any undisclosed information claimed to render inaccurate statements denying the existence of alleged preliminary merger discussions.' Rather, the opinion simply holds that the district court applied an incorrect legal standard of materiality, which was based largely on the decisions in *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (2d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985), and *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982).

Second, this court's decision does not hold that the three statements at issue are material as a matter of law, but rather concludes that the district court erred in holding that no genuine fact existed on the issue of materiality. The record indicates that only the defendants filed motions for summary judgment, and our decision merely reverses the district court's granting of these motions."

ENTERED BY ORDER OF THE COURT

/s/ JOHN P. HEHMAN

John P. Hehman, *Clerk*

FILED

July 2, 1986

United States Court of

Appeals for the Sixth Circuit

SUPREME COURT OF THE UNITED STATES

No. A-961

— ■ —
BASIC INCORPORATED, ET AL.,

Applicants,

—v.—

MAX L. LEVINSON, ET AL.

— ■ —
ORDER EXTENDING TIME TO FILE PETITION FOR
WRIT OF CERTIORARI

UPON CONSIDERATION of the application of counsel for the applicants,

IT IS ORDERED that the time for filing a petition for a writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including August 24, 1986.

/s/ SANDRA D. O'CONNOR

*Associate Justice of the Supreme
Court of the United States*

Dated this 10th day of June, 1986.

**STATUTORY AND REGULATORY
PROVISIONS INVOLVED**

United States Code

Title 15

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

• • •

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Code of Federal Regulations

Title 17

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Federal Rules of Civil Procedure

Rule 23. Class Actions

(a) **PREREQUISITES TO A CLASS ACTION.** One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) **CLASS ACTIONS MAINTAINABLE.** An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

OPPOSITION BRIEF

SEP 22 1986

JOSEPH F. SPANIOLO, JR.
CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 1986

BASIC INCORPORATED; ANTHONY M. CAITO;
SAMUEL EELLS, JR., JOHN A. GELBACH;
HARLEY C. LEE; MAX MULLER; H. CHAPMAN
ROSE; EDMUND Q. SYLVESTER and JOHN
C. WILSON, JR.,

Petitioners,

v.

MAX L. LEVINSON; KARL ZUCKERMAN;
RONALD M. NEWMAN,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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September 22, 1986

36142

Questions Presented

1. Did the Court of Appeals for the Sixth Circuit properly reverse the District Court's grant of summary judgment dismissing an action commenced pursuant to Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder where that dismissal was based on a holding that public statements issued by a corporation denying the existence of merger negotiations at a time when the corporation was, in fact, engaged in active, prolonged and ultimately successful merger discussions could not, as a matter of law, be materially false or misleading to the corporation's shareholders who sold their stock in reliance on the statements?

2. Did the Sixth Circuit properly affirm the District Court's certification of a plaintiff class of persons who sold the corporation's stock after the public statements and where reliance on the statements was presumed under the "fraud on the market" theory?

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IN THE Supreme Court of the United States

October Term, 1986

No. 86-279

BASIC INCORPORATED; ANTHONY M. CAITO; SAMUEL EELLS, JR.; JOHN A. GELBACH; HARLEY C. LEE; MAX MULLER; H. CHAPMAN ROSE; EDMUND Q. SYLVESTER
and JOHN C. WILSON, JR.,

Petitioners,

v.

MAX L. LEVINSON; KARL ZUCKERMAN;
RONALD M. NEWMAN,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

Respondents Max L. Levinson, Karl Zuckerman and Ronald M. Newman respectfully request that the Court deny the Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit ("Petition") submitted by Basic Incorporated ("Basic") and several individuals who were directors of Basic ("defendants") to review a final judgment of the United States Court of Appeals for the Sixth Circuit which (1) reversed the District Court's order granting defendants/petitioners' motion for summary judgment dismissing a federal securities action and (2) affirmed its order granting plaintiffs' motion for class certification.

Statement of the Case

Plaintiffs, who represent the class of Basic shareholders who sold their shares in the fourteen-month period before December 15, 1978, commenced this action in 1979 in the United States District Court for the Northern District of Ohio against Basic and its directors, for violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1981), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1985), promulgated thereunder. They allege essentially that during 1977 and 1978, Basic was actively involved in discussions, preparations and negotiations for a merger with Combustion Engineering, Inc. ("Combustion") which was consummated by Combustion's uncontested tender offer in December 1978. In response to episodic increased trading in Basic's stock, Basic issued a series of public statements flatly denying any merger discussions and denying its knowledge of any corporate developments which would explain the trading activity. The statements were materially false and misleading when issued. Plaintiffs allege that the statements were made to artificially depress the price of Basic's securities and to quell rumors in the market of a merger involving Basic, and that they had such an effect. If Basic had disclosed the information about the merger discussions, or even if Basic had remained silent, the market price of its stock would have reached substantially higher levels. Plaintiffs allegedly were injured because they sold their Basic shares before the merger offer in reliance upon Basic's public statements and received a substantially lower price compared to that of the offer.

The parties engaged in extensive discovery over a number of years. The Court of Appeals summarized the evidence developed by the discovery as set forth below.

Until 1978, Basic was an independent manufacturer of chemical refractories, whose stock was traded on the New York Stock Exchange ("NYSE"). Combustion, engaged

in manufacturing similar products, first became interested in acquiring Basic in 1965 or 1966 but was unable to proceed because of potential antitrust concerns. These concerns were somewhat allayed by a Federal Trade Commission proceeding in 1976. Combustion's Industrial Products Group listed the acquisition of Basic as part of its "Strategic Plan" in October 1976. *Levinson v. Basic Inc.*, 786 F.2d 741, 743 (6th Cir. 1986).

Beginning in September 1976, James Kelly, a Combustion vice-president, held several meetings and phone conversations with Basic's management, including Max Muller, Basic's chairman and chief executive officer, to discuss a merger of the two companies. The discussions included topics such as how Basic would function inside the Combustion corporate structure after it was acquired. In order to assist Combustion in an antitrust investigation of such an acquisition, Muller provided Kelly in October 1976 with confidential, non-public information relating to Basic's sales and operations. *Id.* at 743. The next month, Kelly made a presentation to the Executive Committee of Combustion's Board of Directors about the acquisition of Basic and received authorization to continue his negotiations. Combustion also requested First Boston Corp. ("First Boston"), its investment bank, to prepare analyses of the acquisition of Basic at \$18, \$20 and \$22 per share respectively. *Id.* at 743-44.

In January 1977, Muller informed Basic's Board of Directors of his meetings with Combustion, of Combustion's interest in Basic and of Combustion's study finding no antitrust problems. At a subsequent meeting, Kelly informed Muller of his authorization to negotiate and discussed how Basic's independence would be maintained after acquisition by Combustion. *Id.* at 743-44.

Over the next few months, Basic had its attorneys prepare analyses of a possible merger with Combustion. *Id.* Muller

continued to report to Basic's Board about his contacts with Kelly. In August and October 1977, Basic sought out Kidder, Peabody & Co. for the preparation of a valuation of Basic for use in merger negotiations. The "Strategic Plan" of Combustion's Industrial Products Group, dated September 23, 1977, once again included the acquisition of Basic. *Id.* Accordingly, Kelly met with Muller and others at Basic's office on October 12, 1977, to discuss the place Basic would have in Combustion's corporate structure if an acquisition occurred. *Id.*

Shortly thereafter, amidst rumors of merger activities, Basic's stock underwent an almost four-fold increase in daily trading volume on the NYSE. Muller issued a statement to the press on October 20, 1977, reported in *The Cleveland Plain Dealer* the next day, which read in part:

President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland-based maker of refractories for the steel industry.

Id.

Kelly's contacts with Basic's management continued after the statement denying any negotiations. In a meeting on February 27, 1978, Muller agreed to provide Combustion with non-public information, including sales and earning projections, to assist Combustion in evaluating Basic's business and in preparing an offer for Basic. Financial statements and studies were prepared by Basic's controller and turned over to Combustion. Meanwhile, Basic submitted such information to Kidder, Peabody to obtain an appraisal of Basic's stock value and undertook its own analyses. *Id.* Muller discussed the status of his negotiations at Basic's Board meetings in April and May.

On June 7, 1978, Kelly provided Combustion's analyses of Basic's value and offered \$28 per share for Basic's outstanding stock. Muller rejected the offer as "too low." Kelly then proposed to give Combustion's best offer. Muller, desiring to first receive Kidder, Peabody's appraisal, told Kelly to "hold off" and he would get back to him. *Id.* Basic's management subsequently met with defendant H. Chapman Rose, Basic's attorney, and decided to ask for Combustion's "best offer." Rose advised it to "stay out of the market." *Id.* Basic's attorneys also prepared an analysis of antitrust problems arising from Combustion's acquisition of Basic, based in part on financial information relating to Combustion which was provided by Kelly.

Muller and Kelly agreed in a phone conversation on July 10 that Combustion would prepare a new "informal offer." Kelly advised Muller "against public disclosure" of this offer. *Id.* In order for First Boston to calculate a proper offer, Kelly asked for and received from Basic its non-public earnings forecasts for 1978, 1979 and 1980. The forecasts included a significantly higher estimate of earnings for 1978 than Muller had previously given Kelly and optimistic projections for subsequent years. On July 14, Combustion management held a meeting with First Boston merger specialists concerning possible offers by Combustion and after the meeting it called a special meeting of Combustion's Board of Directors to discuss this subject. *Id.*; see also District Court's Memorandum and Order dated August 3, 1984 (App. 21a-111a) ("District Court Op. I") at App. 81a-85a.¹

As a result of sharply increased trading in Basic's stock on July 14, 1978, the NYSE officer in charge of the stock contacted Basic to make an inquiry about the upsurge.

¹ These citations are to the Petitioners' Appendix To Petition For A Writ Of Certiorari, filed with this Court (hereinafter "App.").

Basic denied there were any "undisclosed merger or acquisition plans," any developments in the area of sales or earnings, any rumors, or any other undisclosed corporate developments. *Levinson*, 786 F.2d at 745.¹

In a phone conversation on July 19, Muller and Kelly discussed the surge in trading and agreed that Combustion should pursue a "slow, deliberate approach" in making its offer to acquire Basic. Muller also would continue to respond to "any outside inquiry" by saying that Basic knew of nothing that could be causing the increased trading in its stock. *Levinson*, 786 F.2d at 744; District Court Op. I at App. 86a-87a. Thereafter, First Boston forwarded to Combustion a draft letter dated September 14, 1978, proposing the acquisition of Basic at \$32 per share and describing the schedule and manner of stock purchases. *Levinson*, 786 F.2d at 745.

Basic's stock once again experienced unusually heavy trading on September 25, 1978. The NYSE again made inquiries of Basic and later that day, Basic issued the following statement to the press: "[M]anagement is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days." *Id.*

¹ This statement and others made by Basic were issued despite the following provision of the NYSE Company Manual applicable to all listed companies:

If rumors or unusual market activity indicate that information on impending [corporate] developments has leaked out, a frank and explicit announcement is clearly required. . . . If rumors are in fact false or inaccurate, they should be promptly denied or clarified. A statement to the effect that the company knows of no corporate developments to account for the unusual market activity can have a salutary effect.

New York Stock Exchange Listed Company Manual § 202.03, "Dealing With Rumors or Unusual Market Activity" (1983) (emphasis added).

Following a Federal Trade Commission decision on October 12, 1978, which eliminated any lingering antitrust problems, Kelly was told that it "would be a good time to get the acquisition done." *Id.* Kelly and Muller arranged a meeting for late November. Before the meeting, Basic issued a "Nine Month Interim Report to Shareholders" dated November 6, 1978, in which it again stated: "With regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months." *Id.*

Kelly met with Muller and Basic's management at Basic's offices on November 27. Kelly proposed an offer to acquire Basic at a price of \$35 per share, which Basic thought was low. During the next weeks, Basic met several times with people from Kidder, Peabody to determine a proper acquisition price. On December 14, Combustion's Executive Committee approved the acquisition of Basic at up to \$46 per share. *Id.* The next day, Basic's stock rose sharply again, resulting in another NYSE inquiry and another denial by Basic of any corporate developments. On December 18, Basic asked the NYSE to suspend trading in its stock and finally announced it had been approached concerning a possible merger. Following meetings between Combustion's and Basic's top management, Basic's Board of Directors accepted Combustion's offer of \$46 per share on December 19 and Basic publicly announced the agreement on December 20, 1978. *Id.*

After extensive discovery, defendants moved for summary judgment on plaintiffs' claims. In a 129-page opinion which reviewed at length the facts in the voluminous record (including those presented above), the District Court granted defendants' motion. It held as a matter of law that none of the three public statements made by Basic constituted materially false or misleading statements in violation

of Section 10(b) and Rule 10b-5. It specifically found that (1) the statement published in *The Cleveland Plain Dealer* on October 21, 1977, was not false or misleading because at that time no merger negotiations had taken place between Combustion and Basic; (2) the public statements on September 25, 1978, and November 6, 1978, were true, and while they did omit information about "preliminary merger discussions" between the two companies, such information was immaterial as a matter of law. District Court Op. I at App. 65a, 99a-102a, 104a. The court below reversed the District Court's grant of summary judgment on the Section 10(b) and Rule 10b-5 claims. It concluded that Basic's three public statements could be considered "misleading, if not totally false" and that the omitted facts about the merger discussions would be "material to making normal reasonable investment decisions." *Levinson*, 786 F.2d at 747-48.

The District Court also certified the proposed plaintiff class under Federal Rule of Civil Procedure 23. It found that each plaintiff's reliance on defendants' public statements could be presumed by application of the "fraud on the market" theory. District Court's Memorandum and Order dated December 10, 1981, (App. 113a-127a) and February 17, 1982 (App. 128a-140a). The Court of Appeals affirmed the class certification. *Levinson*, 786 F.2d at 749.

Reasons for Denying the Petition

I.

Plaintiffs' Section 10(b) and Rule 10b-5 Claims Involve Issues of Fact to Be Resolved by the Trier of Fact

The District Court's decision granting summary judgment in favor of defendants was properly reversed because it determined as matters of law questions which are pecu-

liarily suited for the trier of fact. The Court of Appeals did not make new law but simply followed well-established authority requiring such issues to be tried as factual issues on a case-by-case basis.

A. The Question of Whether Basic's Public Statements Were Materially False or Misleading Raises Essential Issues of Fact.

The law governing the duty to disclose information under Section 10(b) and Rule 10b-5 is well-established. While an affirmative duty to disclose exists only in limited circumstances, once an affirmative disclosure is voluntarily made, a duty arises to tell the entire truth about the subject of the disclosure. *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 758 (3d Cir. 1984), *cert. denied*, — U.S. —, 105 S. Ct. 1189 (1985); *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 861-62 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). Rule 10b-5 expressly provides in relevant part that it is unlawful for anyone to make, in connection with the purchase or sale of a security, "any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b) (1985). In the seminal case concerning misrepresentations or misleading statements, *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, the Second Circuit stated that "Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media . . . if such assertions are false or misleading or are so incomplete as to mislead" 401 F.2d at 862. Or as another court stated more simply, "[A] duty to speak the full truth arises when a defendant undertakes to say anything." *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1317 (5th Cir. 1977), *cert. denied*,

435 U.S. 952 (1978).³ The broad policy underlying Rule 10b-5 is to ensure full disclosure of material information to the investing public and to protect the integrity of the stock market. *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963); *Texas Gulf Sulphur*, 401 F.2d at 848.

Under the *Texas Gulf Sulphur* test, a public statement is misleading in violation of Rule 10b-5 when a "reasonable investor in the exercise of due care, would have been misled by it." *Id.* at 863 (emphasis added). A claim must establish that (1) the statement is "reasonably calculated" to influence the investing public; (2) it includes false facts or omits facts; and (3) such facts are material. *See also* 17 C.F.R. § 240.10b-5(b). All these elements are clearly issues of fact to be decided by the fact-finder. This Court has stated the test of materiality of facts under Rule 10b-5 to be whether a "reasonable investor might have considered them important in the making of [an investment] decision." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 154 (1972) (emphasis added). Similarly, in an analogous context, it has defined a fact to be "material" if there is "a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder" or a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (emphasis added).

³ Furthermore, if a voluntary statement is correct when issued, a corporation has a duty to update that statement if it becomes materially misleading in light of subsequent events. *Greenfield*, 742 F.2d at 758; *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243 (S.D.N.Y. 1962).

Such standards of "reasonableness" dictate resolution by a jury or fact-finder. Rather than creating "a specific rule as to when information respecting a merger becomes material" under Rule 10b-5, the courts have generally emphasized that materiality must be determined "on a case-to-case basis according to the fact pattern of each specific transaction." *Securities and Exchange Commission v. Shapiro*, 494 F.2d 1301, 1306 (2d Cir. 1974); *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 888 (2d Cir. 1972); *see also Grigsby v. CMI Corp.*, 765 F.2d 1369, 1373 (9th Cir. 1985). In a case almost identical to the present one which addressed the materiality of omitted information about merger discussions, the court found "such a determination is peculiarly within the province of the trier of fact." *Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128, 134 (S.D.N.Y. 1984) (citing *TSC Industries*); *see also Etshokin v. Texasgulf, Inc.*, 612 F. Supp. 1220, 1228-30 (N.D. Ill. 1985).

The lengthy and complex factual record of this case made the resolution of these issues of fact through a summary judgment motion particularly inappropriate. Federal Rule of Civil Procedure 56 allows the entry of summary judgment only when "there is no genuine issue as to any material fact" and "the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). The moving party has the burden of showing conclusively that there is no issue of material fact. All facts and all reasonable inferences which can be drawn from them must be viewed in a light most favorable to the party opposing the motion. *Adickes v. S.H. Kress and Co.*, 398 U.S. 144, 157 (1970); *United States v. Diebold, Inc.*, 369 U.S. 654, 655 (1962).

This Court in *TSC Industries* has already expressed its disfavor with deciding through summary judgment the issue of the materiality to investors of omitted or misstated facts in a misrepresentation action under federal securities law:

In considering whether summary judgment on the issue is appropriate, we must bear in mind that the underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. *The determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.*

TSC Industries, 426 U.S. at 450 (emphasis added and footnotes omitted).

Notwithstanding the facts in the record summarized above, the District Court below concluded that no issue of fact was raised as to the materially misleading nature of Basic's public statements. In deciding that no reasonable investor would consider the evidence of the merger discussions between Basic and Combustion, in light of Basic's public statements, significant in making his investment decision, the District Court persistently read the evidence presented in the narrowest of possible lights and viewed it in isolation from the other evidence in the record. Finally, it impermissibly substituted its own judgment for that of the fact-finder at trial as to whether the evidence of dealings and discussions between Basic and Combustion, in light of the public statements made, would have been material to the decision of a reasonable investor.

The Court of Appeals properly applied the elementary law discussed above and reversed the District Court's summary judgment. The Sixth Circuit recognized that the record "illustrates that a merger of the corporations was the purpose of these contacts [between Kelly and Basic] and . . . the conversations focused on that topic" and that the public statements could reasonably be read to deny the

existence of acquisition discussions. Thus, the court realized that such misrepresentations or omissions could assume significance in the decisions of a reasonable investor. *Levinson*, 786 F.2d at 747-48.

B. The Court of Appeals Did Not Create a Presumption That All Merger Discussions Are *Per Se* Material.

While accepting the fact-specific nature of the materiality issue as outlined by this Court in *TSC Industries*, petitioners have attempted to read into the Sixth Circuit's decision "a standard under which any information relating to preliminary merger contacts is deemed material—without regard to whether it was of such a nature that it reasonably 'would have assumed actual significance [in the deliberations of the reasonable shareholder].'" Petition at 20 (quoting *TSC Industries*). This contention exaggerates and distorts the Sixth Circuit's opinion, which nowhere states such a broad rule requiring the disclosure of all information about any merger discussions.

The court below simply ruled that, *on the individual facts of this case*, the particular false and misleading public statements made by Basic were material as a matter of law. In the court's own words, "We . . . find it 'inconceivable' that Basic stockholders would not find the fact that discussions were occurring between Combustion and Basic, in light of Basic's statements, to be important and, therefore, material to making normal reasonable investment decisions." *Levinson*, 786 F.2d at 748 (quoting *Holmes v. Bateson*, 583 F.2d 542, 558 (1st Cir. 1978)). The court does not purport anywhere to extend its findings with respect to these unique and compelling facts to the level of a new rule of law.

The opinion fully comports with the standards enunciated in *TSC Industries*, where this Court remarked that the issue

of materiality can be decided as a matter of law "if the established omissions are 'so obviously important to an investor, that reasonable minds cannot differ on the question of materiality.'" *TSC Industries*, 426 U.S. at 450 (quoting *John Hopkins University v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970)). The significance of facts about an undisclosed event can be judged by balancing "both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." *Texas Gulf Sulphur*, 401 F.2d at 849. The materiality of the facts presented above to a reasonable Basic shareholder is self-evident. Not only were Basic shareholders deprived of knowing that there was a substantial likelihood, or at least a real possibility, that their company was to be acquired by a major corporation through a tender offer at a price significantly above their stock's current value, but they were affirmatively given information which clearly *denied* the existence of those facts. Respondents submit that the Sixth Circuit justifiably concluded that the truth about the merger negotiations necessarily would have been material to Basic shareholders. Indeed, it would be hard to imagine a set of facts from which it could be concluded so obviously that investors had been deprived of important information about their company.

II.

There Is Not a Direct Conflict Between the Third and Sixth Circuits on the Standard of Materiality in "Voluntary Disclosure" Cases Under Rule 10b-5

The primary reason advanced by petitioners for issuing a writ of certiorari—that "there is a direct conflict between the Third and Sixth Circuits on the standard of materiality"—is inaccurate. Petition at 9. It reflects a confusion of the

"nondisclosure" and "voluntary disclosure"⁴ cases regarding the disclosure of merger discussions under Rule 10b-5 and an incorrect reliance on the Third Circuit's *Greenfield* opinion.

A. The *Greenfield* Court Recognized the Distinction Regarding the Duty to Disclose in Nondisclosure and Voluntary Disclosure Cases.

In *Greenfield*, a divided Third Circuit panel affirmed summary judgment in favor of defendant Heublein on a Rule 10b-5 claim alleging that Heublein had issued a false and misleading public statement relating to its merger discussions with R.J. Reynolds Tobacco Co. ("Reynolds"). Days before the statement was issued, Heublein's management had a confidential meeting with Reynolds to discuss the possibility of Reynolds' becoming a "white knight" and arranging a friendly merger in order to avert a possible hostile takeover by General Cinema Corp., which had purchased a large block of Heublein stock and had recently made a series of non-negotiable demands of Heublein. At the meeting, Reynolds discussed how the two companies could be integrated, but no agreement was reached. Trading activity in Heublein's stock soon increased, and when the NYSE made an inquiry, Heublein issued a statement that it "was aware of no reason that would explain the activity in its stock in trading on the NYSE today." Heublein continued its negotiations with General Cinema shortly after its public statement, but when those negotiations reached an impasse, Heublein sought out Reynolds and reached a merger agreement with it. 742 F.2d at 753-54.

⁴ These terms are employed in this brief to denote the following: "Nondisclosure" cases are those involving claims under Rule 10b-5 where the defendant has not publicly disclosed any information relating to a given subject—e.g., merger discussions. "Voluntary disclosure" cases are those where the defendant does make a voluntary public statement about the subject.

The *Greenfield* court was presented with two distinct issues. First, when did Heublein have a duty to initially affirmatively disclose its merger negotiations with Reynolds, and second, was the voluntary public statement made by Heublein materially misleading when issued or afterwards? As to the first issue, the three judges followed the precedent of *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982), holding that no affirmative duty to disclose merger discussions occurs until "an agreement in principle [to merge] has been reached." *Staffin*, 672 F.2d at 1207. Such an agreement in principle, the *Greenfield* majority remarked, generally requires agreement on the price and structure of the merger. Thus, preliminary merger discussions, such as those between Heublein and Reynolds, were immaterial as a matter of law. *Greenfield*, 742 F.2d at 756; *Staffin*, 672 F.2d at 1205-07. As another court has explained,

The rationale emerging from these cases is that when dealing with complex bargaining which may fail as well as succeed and which may succeed on terms which vary greatly from those originally anticipated, the disclosure of preliminary discussions could very easily mislead shareholders as to the prospects of success, and by making public an impending offer, push the price of the target's stock toward the expected tender price, thereby depriving shareholders of the primary inducement to tender—a premium above market price—and forcing the offeror to abandon its plans or greatly increasing the cost of the offer.

Starkman v. Marathon Oil Co., 772 F.2d 231, 243 (6th Cir. 1985), *cert. denied*, — U.S. —, 106 S. Ct. 1195 (1986). Several other courts have reached this same conclusion on this issue. *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11, 14 (2d Cir. 1983); *Missouri Portland Cement Co. v. H.K. Porter Co., Inc.*, 535 F.2d 388,

398 (8th Cir. 1976); *Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075, 1085-86 (th Cir. 1970).

But as the Court of Appeals in this case properly reasoned, the District Court and petitioners wrongly relied on these nondisclosure cases and their rationale as being applicable to the present case, which involves the duty to disclose in the event of a voluntary public misrepresentation. This distinction was recently stressed in *Schlanger*, where defendants issued a statement that the corporation was "not aware of any corporate developments" which would account for the increased trading of its stock after it had been privately engaged in merger discussions with other companies. 582 F. Supp. at 129. The court emphasized that, unlike in cases such as *Staffin* and *Reiss*, "defendants *did* make an announcement, intended to be relied on by purchasers and sellers, and therefore had a duty to make a statement which was both truthful insofar as it went, and not misleading in light of the facts known at that time." *Id.* at 133 (emphasis in original). In determining whether Heublein's voluntary public statement violated Rule 10b-5, even the *Greenfield* majority recognized that it had to apply a different standard—that enunciated in *Texas Gulf Sulphur*—from that which it applied in determining whether Heublein had an affirmative duty to disclose the merger discussions in the first place.

The courts' different treatment of the duty to disclose merger discussions in nondisclosure and voluntary disclosure cases has clear rationales. Imposing an affirmative duty to disclose such discussions when a corporation has maintained silence forces the corporation to reveal information against its will and sometimes against its interest. As the courts have noted, there is a danger that certain disclosures regarding merger negotiations may be misleading and counter-productive if required to be made prematurely. These concerns, however, are not present when a public corporation voluntarily and willfully makes a misleading

public statement with the intention, as alleged here, to affect the stock market. Under these circumstances, the imposition of a higher duty to state the whole truth in a voluntary public statement is warranted in order to preserve the integrity of the market. Moreover, while corporate silence about merger discussions in a sense maintains the *status quo* among shareholders, the issuance of false or misleading statements significantly alters the *status quo*. The Securities and Exchange Commission ("SEC"), appearing as an *amicus curiae* in the court below, commented that the issuance of such statements will cause certain investors to make investment decisions which harm them in a very tangible way. Brief of the Securities and Exchange Commission, *Amicus Curiae* at 23, *Levinson v. Basic*, 786 F.2d 741 (6th Cir. 1986) ("SEC Brief").

Also, a corporation's voluntary issuance of a statement about a subject may cause greater significance to be attached to that subject than if the corporation had said nothing about it. The very fact that the company initially issued a public statement about the subject attests to its materiality in the corporation's perception. Thus, information which would not be material to a reasonable investor when nothing is said about it may become material when a misrepresentation is made about it. As the court below observed,

When a company whose stock is publicly traded makes a statement, as Basic did, that 'no negotiations' are underway, and that the corporation knows of 'no reason for the stock's activity,' and that 'management is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity,' information concerning ongoing acquisition discussions becomes material by virtue of the statement denying their existence.

Levinson, 786 F.2d at 748 (emphasis in original).

Finally, applying the rule of the materiality of ongoing merger negotiations enunciated in nondisclosure cases, such as *Staffin*, to voluntary disclosure cases leads to anomalous and clearly improper results. A company could release false and misleading statements about ongoing merger negotiations right up to the time an "agreement in principle" has been reached and would not be accountable under Rule 10b-5 because such statements would be immaterial as a matter of law.

B. The Greenfield Majority Did Not Directly Address the Standard of Materiality in Voluntary Disclosure Cases.

The second issue facing the *Greenfield* panel, and the one involved in the present case, was whether Heublein's public statement that it "was aware of no reason that would explain the activity of its stock in trading on the NYSE" was materially false or misleading in violation of Rule 10b-5. Employing an unreasonably narrow reading of the public statement, the majority concluded on the basis of the facts in the case that the statement was "not false, inaccurate, or misleading." 742 F.2d at 759. It noted that Heublein's previous merger discussions with Reynolds were confidential at the time of the statement and no evidence had been produced showing that these discussions had been leaked to outsiders. Even though Heublein's management "clearly knew of information that *might* have accounted for the increase in trading" (i.e., its merger discussions with Reynolds), it did not *know* for certain what caused the trading. *Id.* (emphasis added).

Respondents submit, as Judge Higginbotham convincingly argued in his dissent in *Greenfield*, that the majority erred because of its overly literal reading of Heublein's public statement. *Id.* at 760 (Higginbotham, J., dissenting). Such a reading of this statement, and similar statements which are commonly issued by a corporation in re-

sponse to stock exchange inquiries when unusual trading in its stock has occurred,³ eviscerates their significance. Corporate managers generally never truly know with certainty what is causing the increased stock trading by investors on the market and they can easily avoid learning about possible causes. Thus, under the *Greenfield* majority's ruling, unless managers know for certain that a leak of material information has occurred, they can withhold such material information and issue statements of their ignorance.

Such a standard, however, ignores the reality of the corporate world, where leaks of confidential, non-public information are prevalent and the basis of much stock trading activity. *Id.* at 763-64 (Higginbotham, J., dissenting). Where management knows undisclosed material information concerning a corporate development such as a merger, where such information very possibly could have been leaked to outsiders, and where such information, if leaked, is capable of causing the unusual stock trading activity which is occurring, a public announcement by the corporation that it is "aware of no reason that would explain the activity in its stock" must be judged to be false or deceptive. Moreover, the *Greenfield* majority's narrow reading of this statement disregards the meaning which a *reasonable investor* would attach to the statements. Since the basic purpose of Rule 10b-5 is to ensure that all investors have equal access to information significant to their investment decisions, the test of the truthfulness of the statement should focus on how the reasonable investor reads and understands it, not how the issuer of the statement narrowly interprets it. As the court below correctly opined, "[E]ven if Basic, for some reason, never knew the reason for the unusual market activity, the statements were misleading in that they could

³ See New York Stock Exchange Listed Company Manual § 202.03, *supra* at p. 6 n.2; American Stock Exchange Company Guide § 401, "Outline of Exchange Disclosure Policies" (1983).

reasonably be read broadly by the public as flat disclaimers of any significant corporate developments that might account for the high volume stock activity." *Levinson*, 786 F.2d at 747 (emphasis in original).

For purposes of this Petition, however, the critical point is that the *Greenfield* majority *only* ruled that the public statement was *not false or misleading* at the time it was made. It did *not* rule on the issue of whether the statement, if false or misleading, would be materially so as required by Rule 10b-5. It did not address the materiality issue in its consideration of whether the voluntary statement which was made violated Rule 10b-5; it only addressed the materiality issue in its consideration of the first issue—the duty to initially and affirmatively disclose merger discussions. Thus, respondents submit that, contrary to petitioners' assertions, there is not a "direct conflict" between the Third and Sixth Circuits on the standard for materiality in the context of a voluntary public statement denying knowledge of any developments that would account for a surge of stock trading when, in fact, merger discussions involving the company have occurred.

C. The Securities and Exchange Commission Rejects the District Court's Ruling on the Materiality of Merger Discussions in Voluntary Disclosure Cases.

As set forth above, respondents submit that the Third Circuit's opinion in *Greenfield*, while aberrational and in error, does not directly conflict with the Sixth Circuit's opinion here. To the extent that it could be construed as addressing the standard of materiality in a voluntary disclosure case, it is simply wrong.

In a case much more factually and legally analogous to the present case, *Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128 (S.D.N.Y. 1984), defendants had issued a public denial of knowledge of "any corporate developments" which would explain a surge of increased trading

in its stock, when it had engaged in several merger discussions and meetings with another company but when no formal offer had been made yet. *Id.* at 129. As here, the plaintiff class, composed of stockholders who had sold their shares in reliance on the public denial before the merger was announced, alleged that defendants had issued the false and misleading public denials in order to artificially depress the stock price. The court distinguished *Reiss* and *Staffin*, on which those defendants also relied, from a voluntary disclosure case and denied defendants' motion for summary judgment. It found "contested issues of fact" as to the truth and materiality of the public statement which had to be resolved at trial. *Id.* at 133.

The SEC, the agency primarily responsible for the interpretation and enforcement of Rule 10b-5, has advocated the same determination of these issues. The SEC, appearing as *amicus curiae* below, roundly attacked the District Court's holding that, as a matter of law, false and misleading statements about merger discussions do not become material until an agreement in principle between the parties is reasonably certain. It believed that holding not only to be contrary to the case law, but also potentially to have "a serious adverse impact on investor protection, both in private actions brought by investors and in law enforcement actions brought by the Commission." SEC Brief at 3.

The correct approach to the issue of materiality of merger discussions in cases such as the present one, according to the SEC and the clear weight of the case law, is a fact-specific inquiry in each case as to whether the information would be significant to a reasonable investor. In certain cases, the discussions may become material before it is certain that an agreement in principle to merge will be reached. An evaluation must be made of the significance of the merger to the corporation and the probability that the merger will occur. *Texas Gulf Sulphur*, 401 F.2d at 849.

Thus, "a merger may be such a significant event in a corporation's life that investors would consider negotiations that hold out even a possibility of such a merger to be significant." SEC Brief at 2-3. The Sixth Circuit's opinion embodies this approach. Adoption of this flexible approach, rather than a strict *per se* rule as adopted by the District Court, ensures that fraudulent and deceptive conduct will not escape the purview of the federal securities law.⁶

Contrary to petitioners' arguments, plaintiffs' claims under Section 10(b) and Rule 10b-5 is neither novel nor a threat to responsible corporate management. Basic's management had obvious, viable alternatives to issuing its misleading public statements. If it did not want to voluntarily disclose the merger negotiations, it could have remained silent until an agreement in principle was attained. In response to NYSE inquiries, it could have made no comment or otherwise abided by the NYSE's rules. *In re Car-*

⁶ While the SEC took no position below on the merits of this case, it did issue a report recently in a case very analogous to the present one, *In re Carnation Co.*, Sec. Exch. Act Rel. No. 22214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985.) There, Carnation's and Nestle's management had several confidential meetings at which the price and structure of a merger were discussed and no agreement was reached. Meanwhile, market rumors and articles on a possible acquisition by Nestle appeared, and Carnation stock trading surged. Carnation issued a statement that there were "no corporate developments that would account for the stock action." *Id.* at 87,594. Carnation subsequently provided Nestle with non-public sales information and projections, and sought advice from its investment bankers on a fair price. When trading again surged, Carnation issued another statement that it was not negotiating with anyone and knew no reason for the upsurge. Nestle then made some offers which Carnation rejected, followed by a written offer to Carnation's board of directors and shareholders, which ultimately led to an agreement. The SEC, expressly disagreeing with *Greenfield*, stated, "[A]n issuer statement that there is no corporate development that would account for unusual market activity in its stock, made while the issuer is engaged in acquisition discussions, may be materially false and misleading" under Rule 10b-5. *Id.* at 87,596, n.8 (emphasis added). It found Carnation's two public statements to be materially misleading, if not false.

nation Co., [1984-85 Transfer Binder] Fed. Sec. L. Rep. at 87,595-96 n.6. In its *amicus* brief below, the SEC saw little practical problem for a corporation to abide by the law in circumstances such as those facing Basic here:

Where a company does choose to speak about corporate developments, such disclosure does not have to mislead shareholders into false optimism about merger prospects. It should be possible for a corporation to disclose that it is engaged in preliminary talks toward a possible merger, that there is no agreement to merge, and that the results of the talks cannot be predicted. . . . If investors then choose to base their investment decisions on that disclosure, they are doing so with knowledge of the risks that no merger may occur. It is difficult to see how they would thereby be misled.

A final concern . . . is that disclosure of preliminary merger negotiations could inhibit such negotiations. . . . If a company refrains from trading in its stock, and does not otherwise make statements regarding corporate developments, it should usually be able to negotiate in secrecy. Second, even if some facts regarding negotiations have to be disclosed, many details, including the identity of the other party to the talks and the precise terms discussed, may often remain secret. Thus, the limited disclosure required in such cases should not ordinarily inhibit negotiations. In any event, however, this concern cannot justify deceptive conduct.

SEC Brief at 23-25 (citations and footnotes omitted).

Thus, the Sixth Circuit's decision restoring plaintiffs' claims under Section 10(b) and Rule 10b-5 is soundly based in established legal precedent and in policy. As discussed previously, these claims predominantly hinge on the unique facts of this case. After seven years of pre-trial pro-

ceedings, plaintiffs should have the opportunity to prove their case at trial. Respondents respectfully submit that this Court need not review the decision below.

III.

The Court Below Correctly Affirmed Plaintiff Class Certification Through Use of the "Fraud on the Market" Theory

The District Court certified under Federal Rule of Civil Procedure 23 the plaintiff class of Basic shareholders who sold shares between October 21, 1977, and December 15, 1978. It found the specific requirement of Rule 23(b)(3)—"that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members"—was met through application of the "fraud on the market" theory. District Court's Memorandum and Order dated December 10, 1981 (App. 113a-127a) and February 17, 1982 (App. 128a-140a). The theory, simply stated, is that in a Section 10(b) and Rule 10b-5 action, the element of reliance is presumed once material misrepresentations affecting the price of stock traded on an open market are established.

The court below affirmed the District Court's ruling on class certification. It concluded that plaintiffs had properly alleged all elements of the "fraud on the market" theory: (1) defendants made public misrepresentations; (2) the misrepresentations were material; (3) the stock was traded on an efficient market; (4) the misrepresentations would induce a reasonable, relying investor to misjudge the value of the stock; (5) plaintiffs traded in the stock between the time when the misrepresentations were made and the time when the truth was revealed. *Levinson*, 786 F.2d at 750.

The "fraud on the market" theory serves as an alternative to establishing the traditional element of reliance in securi-

ties fraud claims. The basic premise of the theory is that when material misrepresentations about a corporation are publicly made and there exists an open and efficient stock market, buyers and sellers of the stock will act in reliance on the misrepresentations, which will result in a distortion in the true value of the stock. Plaintiffs who then transact in the stock through the market, relying on the integrity of the market price, are injured by the distortion in stock price. Thus, even if plaintiffs did not rely directly on the material misrepresentations, they were affected indirectly by the effect of such misrepresentations on the stock value in the market. See Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143 (1982).

Six of the circuits now have approved the use of this theory in securities fraud actions involving public misrepresentations and stock transactions on an open, efficient market. *Levinson*, 786 F.2d at 751; *Lipton v. Documentation, Inc.*, 734 F.2d 740, 745 (11th Cir. 1984), *cert. denied*, — U.S. —, 105 S. Ct. 814 (1985); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330, 1332 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462, 469-70 (5th Cir. 1981) (en banc), *cert. denied*, 459 U.S. 1102 (1983); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). All these cases involved proposed class actions. Indeed, the theory would appear "most sound" when used to maintain class actions based on common misrepresentations made on an open market; otherwise, individual issues of subjective reliance of class members might predominate over common issues of law or fact and defeat many class actions to enforce the federal securities law. *Lipton*, 734 F.2d at 743; *Blackie*, 524 F.2d at 903. Commentators also generally have favored use of the

"fraud on the market" theory. See *Rapp, Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 Wash. & Lee L. Rev. 861 (1982); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 Geo. Wash. L. Rev. 627 (1982); Note, *supra* p. 26.

In the present case, plaintiffs have clearly alleged that Basic issued material misrepresentations in public statements relating to the existence of merger discussions. These misrepresentations allegedly caused the quieting of the market in Basic's stock and the artificial deflating of the stock price. Plaintiffs, relying on the integrity of the market price, then sold their Basic stock at these distorted values. These transactions all took place on the NYSE, clearly an open, impersonal and efficient market for the stock.

Petitioners contend that the "fraud on the market" theory should not be applied here to a plaintiff class of stock sellers who sold over a fourteen-month period of time. Petition at 26. Petitioners offer no legal authority or commentary expressly drawing distinctions in the application of this theory based on the status of plaintiffs as stock buyers or sellers, or the time frame in which they transacted in the stock. Instead, petitioners suggest, again without any authority, that "[d]ecisions to sell are likely to be highly individualized, reflecting primarily the particular financial condition and investment requirements of each seller, rather than the market price of the stock." Petition at 26.

Contrary to such unsupported assertions, the "fraud on the market" theory is logically applicable to plaintiff sellers. Material public misrepresentations result through the workings of an open and efficient stock market in the deflation of the stock price, and sellers, relying on the integrity of the price, sell stock on the market at a lower price than the true value of the stock. See *Schlanger v. Four-*

Phase Systems, Inc., 555 F. Supp. 535 (S.D.N.Y. 1982). If the assumption is accepted that the market reflects all available public information including any material misrepresentations made, then it logically would reflect misrepresentations and misleading statements which omit *favorable* corporate developments as well as those which omit unfavorable corporate developments.

Petitioners additionally contend that it is unlikely that all the Basic shareholders reacted to the alleged misleading statements in the same manner or to the same degree during the fourteen-month period, and that a reasonable investor would not have been affected by the statements.⁷ Such factual contentions, however, need not be determined in initially deciding class certification. See 7B C. WRIGHT, A. MILLER & M. KANE, FEDERAL PRACTICE AND PROCEDURE: CIVIL 2D § 1785 at 128-136 (1986). Plaintiffs have alleged sufficiently that the misleading statements artificially depressed the market in Basic's stock throughout the fourteen-month period and the court is bound to accept these allegations as true at this point in the case. *Blackie*, 524 F.2d at 901.⁸ At trial, defendants can rebut the factual elements which plaintiffs must prove to establish the "fraud on the market" theory—e.g., "that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the stock." *Levinson*, 786 F.2d at 750. Moreover, defendants can rebut the entire presumption of reliance established under the theory by showing

⁷ The *Blackie* court, rejecting similar contentions where the proposed class included all stock purchasers over a 27-month period, concluded that where defendants allegedly had engaged in a common course of conduct involving the issuance of "similar misrepresentations" during that time, common questions of law or fact were presented. 524 F.2d at 902-05.

⁸ The District Court made the class certification alterable before the decision on the merits is made if the circumstances should warrant it. District Court's Memorandum and Order dated December 10, 1981, at App. 123a; see also Fed. R. Civ. P. 23(c)(1).

that the number of traders who relied on the misrepresentations was insufficient to distort the market price, or that an individual plaintiff traded despite knowledge of the falsity of a misrepresentation. *Id.* at 750 n.6. But at this stage, as the court below concluded, plaintiffs have alleged sufficiently as a matter of law the elements required for application of the "fraud on the market" theory and thus alleged sufficiently plaintiffs' reliance on defendants' misrepresentations. The certification of a plaintiff class was properly affirmed.

CONCLUSION

For the foregoing reasons, the Petition For A Writ Of Certiorari to review the decision of the United States Court of Appeals for the Sixth Circuit should be denied.

Respectfully submitted,

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September 22, 1986

REPLY BRIEF

IN THE
Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust, and
RONALD M. NEWMAN,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITIONERS' REPLY BRIEF

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS, JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER, H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C. WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as trustee under the Karl Zuckerman Revocable Trust, and RONALD M. NEWMAN,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITIONERS' REPLY BRIEF

I. THE COURT BELOW FORMULATED AN INCORRECT LEGAL PRINCIPLE FOR THE DETERMINATION OF THE MATERIALITY OF UNDISCLOSED INFORMATION

A. Respondents Misread The Decision Below In Asserting That It Did Not Formulate A Legal Standard To Determine Materiality

In their Brief in Opposition ("Opp. Br."), respondents contend that the Sixth Circuit did not establish a legal standard of materiality but merely determined that there were genuine issues of fact concerning the contacts between Basic and C-E which rendered the grant of summary judgment to petitioners inappropriate. Indeed, respondents assert that no court has

formulated a standard under which materiality can be determined as a matter of law: "[r]ather than creating 'a specific rule as to when information respecting a merger becomes material' under Rule 10b-5, the courts have generally emphasized that materiality must be determined 'on a case-to-case basis according to the fact pattern of each specific transaction.'" Opp. Br. p. 11.¹

Any determination of the materiality of undisclosed information, however, cannot be made in a vacuum—the facts relevant to the particular matter must be analyzed in light of controlling legal principles. Whether a determination of materiality is made on a motion for summary judgment or after trial, a uniform legal standard must exist to provide a basis to evaluate relevant factual issues on a case-by-case basis. The issue raised by this Petition is the proper formulation of that standard.

The Sixth Circuit formulated a novel legal principle under which, upon the issuance of a no corporate developments statement, any contact with a third party expressing an interest in an acquisition—no matter how tentative or inconclusive—becomes material and must be disclosed: "even discussions that might not have been material in the absence of the denial are material because they make the statement made untrue." App. 14a-15a. As demonstrated in the Petition, by holding that the materiality of undisclosed preliminary merger contacts could be determined without regard to the significance of those contacts at the time a no corporate developments statement is

¹ At one point respondents assert that this Court's decision in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), essentially precludes a grant of summary judgment based on a finding that particular facts, as a matter of law, are not material (Opp. Br. pp. 11-12). Yet, at another point, they argue that *TSC* does not preclude a determination that particular facts are material. Opp. Br. pp. 13-14. In fact, in *TSC*, plaintiff had been awarded summary judgment on the ground that certain omissions in proxy materials were material as a matter of law. This Court reversed because, on the record before it, the alleged omissions were not materially misleading as a matter of law. 426 U.S. at 463.

issued, the Court below enunciated an irrational legal principle unsupported by precedent.

B. Respondents Misread *Greenfield* In Asserting That It Does Not Conflict With The Decision Below

Under the legal principle of materiality formulated in *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, ___ U.S. ___, 105 S.Ct. 1189 (1985), preliminary merger contacts are not material and need not be disclosed in a no corporate developments statement prior to the time that an agreement in principle is reached on terms fundamental to a merger, such as price and structure. The Sixth Circuit expressly recognized that its materiality standard was in conflict with *Greenfield*, stating that *Greenfield* "expressed a view with which we are in disagreement". App. 13a.

Ignoring the Sixth Circuit's acknowledgement of the irreconcilable conflict between its view and that of the Third Circuit, respondents suggest that this Court need not act to resolve any such conflict because *Greenfield* was incorrectly decided: "respondents submit that the Third Circuit's opinion in *Greenfield*, while aberrational and in error, does not directly conflict with the Sixth Circuit's opinion here. To the extent that it could be construed as addressing the standard of materiality in a voluntary disclosure case, it is simply wrong." Opp. Br. p. 21. Respondents' disagreement with *Greenfield*'s holding does not, of course, dispose of its conflict with the decision below.²

Further, respondents argue that *Greenfield* did not consider the standard governing the materiality of, and hence the need to disclose, preliminary merger contacts in a no corporate developments statement. Instead, they assert that *Greenfield* "only addressed the materiality issue in its consideration of

² In support of the decision below, respondents rely on the *amicus curiae* brief submitted by the Securities and Exchange Commission to the Sixth Circuit. But the SEC's *amicus* brief, although critical of *Greenfield*, did not in any way advocate the standard of materiality ultimately formulated by the Court below.

... the duty to initially and affirmatively disclose merger discussions." Opp. Br. p. 21. In effect, respondents argue that *Greenfield* first determined that the preliminary merger contacts were not material and did not have to be disclosed and then independently determined that the issuance of a no corporate developments statement did not create a need for their disclosure. This argument is plainly fallacious. The order in which the two issues are discussed is insignificant; what is significant is that the legal standard of materiality adopted in *Greenfield* was held to be applicable to the situation in which a no corporate developments statement was issued.

Respondents do not, as they cannot, point to any authority which has read *Greenfield* as narrowly as they would. The Sixth Circuit properly read *Greenfield* as holding "that the company's voluntary statement that it knew of no reason for heightened activity of the stock was not misleading because the merger discussions were not material and, therefore, their omission could not have been an '[omission] of a material fact' as prohibited by Rule 10b-5." App. 14a. Similarly, none of the articles cited at pages 10-11 of the Petition, which discuss the obligation to disclose preliminary merger discussions in light of *Greenfield*, reads *Greenfield* as narrowly as respondents claim.

* * *

Respondents are plainly in error in opposing the granting of the Petition by arguing that the Sixth Circuit did not formulate a legal principle of materiality and that its holding, however viewed, does not clearly conflict with *Greenfield*.

II. IT IS IMPROPER TO USE A PRESUMPTION OF RELIANCE TO AVOID THE PREDOMINANCE REQUIREMENT OF RULE 23(b)(3)

Respondents argue that the use of a presumption of reliance to facilitate class certification by circumventing the predominance requirement of Rule 23(b)(3), Fed. R. Civ. P., is appropriate because such certification is conditional and "[a]t trial, defendants can rebut the factual elements which plaintiffs must

prove to establish the 'fraud on the market theory.' " Opp. Br. p. 28. This Court, however, has long recognized the significant *in terrorem* effect of orders certifying large classes in securities cases. See generally Petition at pp. 22-23 and the cases cited therein. Thus, the ordering of class certification is likely to pressure defendants to settle, even where they have meritorious defenses, simply to avoid the enormous burden and expense of trial.

Requiring defendants to wait until the completion of trial for a final determination on class certification, instead of adhering to the mandate of Rule 23(b)(3) that the predominance requirement be satisfied in advance of trial, would, in many instances, deny justice and encourage unwarranted litigation. It is no solace to petitioners, facing the substantial claims of a large class that, if they endure the risk and expense of taking this case to trial, the class might ultimately be reduced in size or eliminated entirely.

As demonstrated in the Petition—and not disputed by respondents—the use of a presumption of reliance represents an unwarranted extension of *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) and improperly circumvents the requirements of Rule 23. The propriety of facilitating class certification by such a device should be reviewed by this Court.

CONCLUSION

Respondents have not cited any case, and petitioners know of none, where misrepresentations concerning, or nondisclosures of, preliminary merger contacts have been held to be material in the absence of allegations of insider trading, tipping or similar actions to secure a benefit from the undisclosed information.

In cases such as *Holmes v. Bateson*, 583 F.2d 542 (1st Cir. 1978), upon which the Court below relied to show that preliminary merger contacts are material, those with knowledge of the contacts had sought to use that knowledge to benefit themselves or had disclosed it to others who sought to use it

improperly. Since a major factor in determining whether events are material is the importance attached to them by those who knew about them (*Securities & Exchange Commission v. Shapiro*, 494 F.2d 1301, 1307 (2d Cir. 1974)), the actions of defendants in those cases showed that they considered the discussions material. Conversely where, as here, there is not even a claim that petitioners attached any importance to the C-E contacts or that they took any action in connection therewith, it is apparent that they did not regard them as material.

Absent such a claim, materiality principles applicable to insider trading cases such as those cited in the Petition at pp. 12-13 n.7 should not be applied here.³ Instead, standards of materiality articulated in *Greenfield, Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982) and *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983) (Petition pp. 18-19) and in cases such as those referred to by the District Court (App. 30a n.9) should be applied here. In these open market and proxy solicitation cases, claims arising from undisclosed information as to alleged preliminary merger contacts fail because, as a matter of law, courts reject the assertion that the information in question is material. As recognized in *Grigsby v. CMI Corp.*, 765 F.2d 1369, 1376 (9th Cir. 1985), in affirming an award of summary judgment for defendants, a more objective test of materiality is appropriate in "open market transactions" than in "direct single purchaser situations".

The present case illustrates the magnitude of the dangers of a simplistic application of the less objective standard developed in the insider trading cases to an open market case especially where a presumption of reliance is applied to facilitate class certification. Under the decision below, a corporation and its

³ See, App. 32a n.11, where the District Court held that principles established in insider trading cases were not applicable here. In addition, as noted by the District Court (App. 98a n. 57), there was "no evidence in the record of any leak of information about Basic and Combustion discussions during the 1977 and 1978 period of increased trading in Basic stock."

management could become virtual insurers of all open market trading following the issuance of a no corporate developments statement. Both from a policy and an economic perspective, such a result would work an injustice and should not be permitted.

For the foregoing reasons, respondents' arguments in opposition to the petition for a writ of certiorari should be rejected and the writ should issue.

Dated: New York, New York
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AMICUS CURIAE

BRIEF

5
No. 86-279

Supreme Court, U.S.
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JOSEPH F. SPANIOLO, JR.

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BRIEF FOR THE UNITED STATES
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QUESTIONS PRESENTED

1. Whether a corporation's merger negotiations are material to investors, for purposes of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, solely by virtue of the corporation having made a statement denying the existence of such negotiations.

2. Whether a plaintiff who traded in a corporation's stock on a securities exchange after the issuance of a materially false statement by the corporation is entitled to a rebuttable presumption that he relied on the integrity of the market price in so trading.

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BRIEF FOR THE UNITED STATES
AS AMICUS CURIAE

This brief is filed in response to the Court's invita-
tion to the Solicitor General to express the views of
the United States.

STATEMENT

1. This is a class action brought by respondents, former shareholders of Basic Incorporated (Basic), against petitioners, the corporation and certain of its officers and directors (Pet. App. 2a). Respondents claim that they sold shares of Basic stock in a market artificially affected by three allegedly false or misleading public statements made by petitioners in violation of Section 10(b) of the Securities Exchange

Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

The first allegedly false public statement, made on October 21, 1977, followed unusual trading activity in the company's stock. Basic released a statement that "the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger." Pet. App. 5a. Respondents claim that when that public statement was issued Basic was in fact engaged in merger negotiations (which ultimately led to a merger) with Combustion Engineering, Inc. (Combustion). See Pet. App. 4a-5a. The second and third allegedly false statements, made on September 25, 1978, and November 6, 1978, stated that Basic's management was "unaware of any present or pending corporate development[s]" that would account for a recent upsurge in trading activity in Basic stock. Respondents contend that these statements were false or misleading because Basic in fact continued to be engaged in merger negotiations with Combustion (see Pet. App. 5a-7a).

On December 20, 1978, after respondents had sold their shares of Basic stock, allegedly as a result of one or more of the three statements, Basic announced its approval of a tender offer by Combustion to acquire all of Basic's outstanding shares at a price substantially in excess of that at which respondents sold (Pet. App. 8a).

The district court certified the action as a class action (Pet. App. 127a). The court stated that the "fraud on the market theory" alleged by respondents permitted reliance by each class member to be presumed and eliminated the need for individual plaintiffs to prove subjective reliance. Based on that deter-

mination the court held that class certification was appropriate under Fed. R. Civ. P. 23 because common class issues predominated over individual issues (Pet. App. 119a). Without such a presumption of reliance, the court said, individual issues would so predominate that class certification would not be appropriate (*id.* at 118a).

The district court subsequently granted petitioners' motion for summary judgment (Pet. App. 112a). The court ruled that Basic's second and third statements were false or misleading,¹ because Basic was engaged in merger negotiations at the time it issued public statements denying the existence of significant corporate developments. But, relying on a modified version of the test for the materiality of merger negotiations announced by the Third Circuit in *Staffin v. Greenberg*, 672 F.2d 1196 (1982), the court ruled that although they were false the statements were not material and thus did not violate Section 10(b) and Rule 10b-5 (see Pet. App. 101a, 104a). Under the test enunciated in *Staffin*, as subsequently reaffirmed and refined by the Third Circuit in *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (1984), cert. denied, 469 U.S. 1215 (1985), merger negotiations are not material until an agreement in principle (defined as agreement on price and structure) has been reached. In this case, the district court held that the negotiations were not material because at the time the statements were made, negotiations had not reached the stage where they were "destined, with reasonable certainty," to result in an agreement in principle (Pet. App. 103a).

¹ The court held that the first statement was not false or misleading (Pet. App. 65a).

2. The Sixth Circuit reversed the district court's order granting summary judgment. The court of appeals concluded that all three of Basic's statements were false or misleading and held that, where a corporation issues a statement denying the existence of merger negotiations or other significant corporate developments, "information concerning ongoing acquisition discussions becomes material *by virtue of the statement denying their existence*" (Pet. App. 13a) (emphasis in original). The court distinguished the present case, where the corporation made false or misleading statements, from situations where a corporation remains silent in the face of a duty to disclose material information. The court stated (*id.* at 14a-15a (footnote omitted)):

In analyzing whether information regarding merger discussions is material such that it must be affirmatively disclosed to avoid a violation of Rule 10b-5, the discussions and their progress are the primary considerations. However, once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue.^[2]

The court below expressly disagreed with the Third Circuit's decision in *Heublein*. It held that at least where corporate statements are involved, merger negotiations need not reach the point of agreement in

² The court added that it was "inconceivable" that Basic stockholders would not find the fact that discussions were occurring between Combustion and Basic, in light of Basic's statements, to be important and, therefore, material to making normal reasonable investment decisions" (Pet. App. 13a).

principle before they become material (Pet. App. 13a-15a).³

- With respect to class certification, the Sixth Circuit agreed with the district court that under the fraud on the market theory respondents were entitled to a presumption of reliance, that common class issues therefore predominated over individual issues, and that class certification therefore was appropriate (Pet. App. 19a).

DISCUSSION

The question when merger negotiations are material is a recurring question under the federal securities laws. Because a conflict exists among the courts of appeals, review by this Court is warranted with respect to this question. In our view, neither the standard enunciated by the court below nor the standard adopted by the Third Circuit is the appropriate standard for determining the materiality of merger negotiations.

With respect to the second question presented—the presumption of reliance under the fraud on the market theory—there is no conflict among the lower courts or with any decision of this Court. Nor is review of this issue necessary, as petitioners contend, to limit abuse of class actions. Accordingly, further review of that issue by this Court is not warranted.

1. a. The proper standard for assessing the materiality of merger negotiations under the federal securities laws is an issue of great importance to com-

³ The court did not articulate a standard of materiality of merger negotiations in cases involving nondisclosure in the face of a duty to disclose. It suggested, however, that "the discussions and their progress are the primary considerations" in assessing materiality in that context (Pet. App. 14a).

panies involved in such negotiations and to their shareholders.⁴ On the one hand, the timing of disclosure of ongoing merger negotiations is a matter of great sensitivity since premature disclosure may affect or scuttle the negotiations. On the other hand, shareholders have a right not to be misled about ongoing negotiations that are material to their investment decisions.

As the court below recognized, there is no general duty to disclose ongoing negotiations, even if the information would be material to investors (see Pet. App. 9a). Disclosure is required only in certain limited circumstances, such as where a company is trading in its own stock, and thus has a duty to disclose all material information,⁵ where the information has leaked from the company into the market⁶ or where

⁴ The standard of materiality of merger negotiations has been the subject of significant recent attention among legal commentators. See, e.g., Brodsky, *Disclosure of Merger Negotiations*, N.Y.L.J., Nov. 6, 1985, at 1; Brown, *Corporate Communications and the Federal Securities Laws*, 53 Geo. Wash. L. Rev. 741, 782-792 (1985); Goldstein, Donnelly & Wurczinger, *Disclosure of a Potential Change in Corporate Control*, 19 Rev. of Sec. & Comm. Reg. 133 (1986); Greene, *Public Disclosure of Merger Negotiations*, N.Y.L.J., Oct. 24, 1985, at 1; Olson, *Revealing Merger Talks: When, How Are Critical*, Legal Times, Oct. 14, 1985, at 11; Poser, *Surprise! The SEC Says You Shouldn't Tell Lies About Merger Negotiations*, Investment Dealers' Digest, Aug. 26, 1985, at 36.

⁵ See, e.g., *Staffin v. Greenberg*, 672 F.2d at 1205; *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), cert. denied, 419 U.S. 830 (1974). See generally *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

⁶ See, e.g., *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981).

regulations promulgated by the Securities and Exchange Commission require disclosure.⁷

This case and the Third Circuit cases—*Staffin* and *Heublein*—all involve not a mere failure to disclose but one or more affirmative statements alleged to be false or misleading. In each case the company was questioned about unusual market activity in its stock and responded by denying that merger negotiations were occurring or by stating that it knew of no corporate development that would account for the unusual market activity. While the federal securities laws do not impose upon a company any general obligation to issue a statement, even in the face of unusual trading activity, a company that chooses to speak cannot make a materially false or materially misleading statement about ongoing negotiations.

The courts below found that at least the second and third statements made by Basic were false or misleading. The courts reached that conclusion because Basic's statements disclaiming knowledge of any corporate development that would account for the stock's unusual market activity were tantamount to denials of ongoing merger negotiations while such negotiations were in fact underway.⁸

⁷ For example, a company may be required to disclose merger negotiations on Schedule 14D-9, which mandates disclosure of merger negotiations undertaken in response to a tender offer. 17 C.F.R. 240.14d-101, Item 7. See *In re Revlon, Inc.*, Exchange Act Release No. 23320, 35 S.E.C. Dkt. 1541, 1550-1552 (June 16, 1986).

⁸ The Third and Sixth Circuits disagree about whether such statements are false or misleading, as well as about the standard of materiality. In *Heublein*, the Third Circuit held, over a strong dissent, that a statement denying knowledge of corporate developments that would account for unusual market

b. In general, information about a corporation is material "if there is a substantial likelihood that a reasonable shareholder would consider it important," in the context of the "total mix" of information available, in making an investment decision regarding the corporation's stock. See *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).⁹ Where a corporate development is certain, its significance to investors depends on its importance to the company's fortunes. But, where an event is not certain to occur, as is the case with a possible merger, the traditional rule is that the materiality of the event "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company[']s activity." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

activity was literally true and was not misleading because the company, even though it "clearly knew of information that might have accounted for the increase in trading," 742 F.2d at 759, did not know that word of merger discussions had leaked out, and thus did not know the reason for the market activity. In the decision below, the Sixth Circuit found that such statements are misleading, since they will be read not in such a narrow literal way but as a denial of any significant corporate developments (Pet. App. 11a). Accord, *In re Carnation Corp.*, Exchange Act Release No. 22214, 33 S.E.C. Dkt. 1025, 1032 n.8 (July 8, 1985).

⁹ *Northway* arose under the proxy solicitations provisions of the Securities Exchange Act, but subsequent decisions have applied its test of materiality in cases arising under Section 10(b) and Rule 10b-5, involving purchases and sales of securities. See, e.g., *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 466 n.4 (7th Cir.), cert. denied, 454 U.S. 835 (1981); *Goldberg v. Meridor*, 567 F.2d 209, 218 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978).

In applying this "probability/magnitude" standard, courts generally have held that the materiality of merger discussions must be judged on the facts in each case,¹⁰ and that even where agreement is far from certain, merger negotiations may be material to investors. "Many cases have held that the serious possibility of the sale of a corporation is material to the value of the corporation's stock in certain situations." *Grigsby v. CMI Corp.*, 765 F.2d 1369, 1373 (9th Cir. 1985) (citations omitted). In *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976)—a case in which "embryonic" merger talks were held to be material—Judge Friendly stated that since "[a] merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death," negotiations "can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high."¹¹

¹⁰ See *Grigsby v. CMI Corp.* 765 F.2d 1369, 1373 (9th Cir. 1985); *SEC v. Shapiro*, 494 F.2d 1301, 1306 (2d Cir. 1974). See also *Michaels v. Michaels*, 767 F.2d 1185, 1195 (7th Cir. 1985), cert. denied, No. 85-752 (Jan. 13, 1986) ("a number of cases do not apply a 'bright line' rule of materiality for merger negotiations").

¹¹ See also *SEC v. Shapiro*, 494 F.2d 1301, 1306-1307 (2d Cir. 1974); *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 368 (2d Cir.), cert. denied, 414 U.S. 910 (1973); *Holmes v. Bateson*, 583 F.2d 542 (1st Cir. 1978) (merger negotiations that had not yet reached the point of discussing terms were nonetheless material); *Rogen v. Ilikon Corp.*, 361 F.2d 260, 266 (1st Cir. 1966) (negotiations, "[e]ven with the possibility of [their] collapse," could be material); *Dungnan v. Colt Industries, Inc.*, 532 F. Supp. 832, 837 (N.D. Ill. 1982) (fact that the defendants were seriously exploring the

c. In contrast to the discerning inquiry in which other courts have engaged, neither the standard adopted by the court below nor the standard adopted

sale of their company was material); *American General Insurance Co. v. Equitable General Corp.*, 493 F. Supp. 721, 744-745 (E.D. Va. 1980) (merger negotiations were material four months before agreement in principle was reached); *Levin v. Marder*, 343 F.Supp. 1050, 1058 (W.D. Pa. 1972) ("preliminary proposal" of merger "may well be material"); *Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128, 131-132 (S.D.N.Y. 1984) (a "no corporate developments" statement issued by a company in the face of unusually heavy market activity in its stock could be materially false or misleading in that it failed to disclose pending merger negotiations that had not reached the point of agreement); *In re Carnation Corp.*, Exchange Act Release No. 22214, 33 S.E.C. Dkt. 1025, 1031-1034 (July 8, 1985) (concluding that it was materially misleading for Carnation to issue two "no corporate developments" statements in response to unusual market activity at a time when it was engaged in preliminary merger discussions that were far from certain to result in an agreement).

The probability/magnitude test does not supplant, but must be considered part of, the *Northway* test of materiality. Thus, the potential merger must not be so remote as to preclude a finding of "a substantial likelihood that a reasonable [investor] would consider [the negotiations] important." 426 U.S. at 449 (emphasis added). For example, a number of courts have held that, on the facts of the cases before them, mere overtures or inquiries about possible mergers were immaterial because the overtures were so tentative as to make a merger a highly remote prospect. See, e.g., *Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075, 1085 (5th Cir. 1970); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965); *Bucher v. Shumway*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,142, at 96,302 (S.D.N.Y. Oct. 11, 1979), aff'd without opinion, 622 F.2d 572 (2d Cir.), cert. denied, 449 U.S. 841 (1980); *Berman v. Gerber Products Co.*, 454 F. Supp. 1310, 1316, 1318 (W.D. Mich. 1978); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 65 (D.N.J. 1974).

by the Third Circuit in *Staffin* and *Heublein* is a proper basis for determining when merger negotiations cross the threshold of materiality. The Third Circuit's test, under which merger negotiations are not material until an agreement in principle is reached, could be read to permit corporations freely to issue intentionally false or misleading statements denying merger talks that any reasonable investor would consider important to his investment decision,¹² misleading investors into making investment

¹² Respondents disagree with this reading of *Heublein* and argue that there is no conflict between the circuits over materiality in an affirmative statement context (Br. in Opp. 14). They contend that *Heublein* holds only that (1) until an agreement in principle is reached there is no *affirmative duty* to disclose negotiations and (2) while a corporation may not make false or misleading statements about the negotiations, *Heublein*'s "no developments" statement was not false or misleading. Respondents argue that because the *Heublein* court did not hold that the "no developments" corporate statement was false or misleading (see note 8, *supra*), the court never considered whether it was material. Had the court reached that issue, respondents suggest, the Third Circuit might have held, as did the Sixth Circuit here, that in a corporate statement context the negotiations were a material event and that the statement was materially misleading.

Petitioners correctly point out (Reply Br. 4) that *Heublein* has not been read, and was not read by the Sixth Circuit, in so limited a fashion. Indeed, the decision itself does not allow such a reading. In the concluding portion of the decision (742 F.2d at 759-760), the court held that the company had no duty to correct its statement because "as a matter of law, it never became materially misleading on the basis of subsequent events" (*id.* at 759 (emphasis added)). The reason for this, the court said, was "because, as previously shown, *Heublein* was never under a duty to disclose" the merger negotiations prior to agreement in principle. In short, the court held that even if a misleading corporate statement is outstanding, it is not material until agreement in principle is reached, a result in conflict with the decision below.

decisions on the basis of incorrect information.¹³ As the Commission has stated in discussing this issue (*In re Carnation Corp.*, 33 S.E.C. Dkt. at 1030):

The importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be overemphasized. To the extent that investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike.^[14]

¹³ Petitioners contend that *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983), supports the Third Circuit's view that merger negotiations never become material until there is an agreement in principle. But there is no indication that the Second Circuit in *Reiss* abandoned that court's traditional approach (see *Geon* and *Shapiro*) of declining to adopt a rigid test. *Reiss* must be read in light of its facts, which involved mere overtures that were not disclosed by a potential *acquiror* to its shareholders, in a situation where the company had not issued a statement, was not leaking word to the market, and was not trying to induce shareholders to sell securities, but rather was trying to induce noteholders to convert their notes to common stock. The court did not purport in *Reiss* to overrule its clear statements in *Shapiro* and *Geon* that merger talks may in some circumstances become material well before their fruition. Indeed, the *Reiss* court did not even cite *Geon*, *Shapiro* or *Texas Gulf Sulphur*. The lower courts in the Second Circuit have not read *Reiss* as overruling the earlier cases and have continued to hold that preliminary merger discussions can be material. See *SEC v. Gaspar*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. Apr. 15, 1985); *Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128, 133 (S.D.N.Y. 1984).

¹⁴ The Third Circuit has articulated two policy rationales for its materiality test: (1) that disclosure of early negotiations could itself be misleading, by inflating hopes of a mer-

Moreover, if merger negotiations are deemed immaterial until an agreement in principle is reached, the corporation, or its insiders who are privy to the negotiations, could acquire the corporation's securities, taking advantage of uninformed shareholders by trading without making any disclosure of the negotiations.¹⁵

While the Third Circuit standard is erroneous, the Sixth Circuit's test does not remedy its deficiencies. Read literally, the opinion below states that a company's false denial of merger discussions is material

ger that may not come to pass; and (2) that requiring disclosure of early negotiations may scuttle the negotiations. See *Heublein*, 742 F.2d at 757; *Staffin*, 672 F.2d at 1206-1207. The first of these propositions—that the English language is incapable of supplying words that disclose merger negotiations without overstatement or understatement—is a frontal assault on the disclosure philosophy of the securities laws. In any event, with respect to both propositions, if a corporation is concerned about misleading investors or upsetting negotiations, it can simply remain silent. Allowing a corporation to issue false or misleading statements is not a proper solution.

¹⁵ In *Staffin*, the disclosure obligations were triggered not by a corporate statement, but by the company's decision to trade in its own stock. 672 F.2d at 1205.

In *Jordan v. Duff & Phelps, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,724 (N.D. Ill. Mar. 17, 1986), appeals pending, Nos. 86-1611 & 86-1727 (7th Cir.), the court adopted the *Staffin/Heublein* test and held that a corporation had no duty to disclose pending merger negotiations to an employee who was leaving the company and from whom it was buying back stock. In fact, the court held that even though the negotiators might have reached an agreement in principle prior to the purchase, the negotiations did not become material until six days after the purchase, when the boards of directors of the companies approved the agreement.

solely because it is untrue.¹⁶ For example, the court stated that "information concerning ongoing acquisition discussions becomes material *by virtue of the statement denying their existence*" (Pet. App. 13a), and that "once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue" (*id.* at 14a (footnote omitted)). This equating of falsehood and materiality has no basis under *Northway*, and would appear to render any false statement, regardless of how trivial, *per se* material.

The decision below can be read instead to mean merely that merger negotiations that might not otherwise be material are heightened in significance, and may become material, when the corporation denies them. Even read this way, however, the decision conflicts with decisions of the Third Circuit and does not provide a satisfactory standard for assessing materiality in particular cases. Read this way the decision does not specify what test of materiality is to be applied to merger negotiations or even what factors are significant in determining materiality or

¹⁶ While the opinion below may be read this way, the court may not have intended such a result. Indeed, one of the judges on the *Basic* panel, concurring in the denial of rehearing en banc, expressly took the position that the decision does not stand for this result (Pet. App. 145a-146a). The other members of the original panel did not join that statement, and thus the possibility remains that the panel intended the result this literal reading would produce. In that event there would be no need for further factual development on remand, the court of appeals having concluded as a matter of law that the corporation's statements are false and material.

what weight the company's statement is to be given in relation to other factors.¹⁷

The proper standard of materiality of merger negotiations is the probability/magnitude test articulated by the Second Circuit and applied in practice by many other courts. Review is warranted to resolve the conflict among the lower courts on this issue and to provide a uniform standard of materiality that furnishes guidance to corporations in this important area and protects investors from false or misleading statements.

2. a. The second question presented in the petition is whether a plaintiff alleging fraud under Rule 10b-5 may, in circumstances where a materially false or misleading corporate statement has been disseminated into the trading market, meet the reliance requirement of the cause of action by invoking a presumption of reliance upon the integrity of the market price. The reliance requirement, derived from the common law of deceit and misrepresentation, is part of the logical chain necessary to establish that the misrepresentation or omission in fact caused the plaintiff's injury. See *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965). Although the requirement is commonly met by showing the plaintiff's subjective reliance on the defendant's statements, see 3 L. Loss, *Securities Reg-*

¹⁷ The interlocutory posture of the case need not dissuade this Court from granting certiorari. If the decision below is read literally, the court below has finally determined that the statements are false and material as a matter of law. Accordingly, the issue warranting this Court's review would not be affected by any proceedings on remand. Even if the panel's opinion is not read so literally, a conflict still exists on an important and recurring question under the federal securities laws.

ulation 1430-1432 (2d ed. 1961), courts have held that proof of actual reliance is not necessary in certain cases, including those alleging a "fraud on the market."

As the court below explained, the fraud on the market theory, which has been adopted by seven other circuits,¹⁸ "is based on two assumptions: first, that in an efficient market the price of a stock will reflect all information available to the public," so that public misrepresentations cause the market price to be distorted up or down, and "second, that an individual relies on the integrity of the market price when dealing in that stock" (Pet. App. 17a). These two assumptions combine to allow a rebuttable presumption that investors who traded relied "indirectly on the misrepresentation" that caused a price distortion in the market (*ibid.*). See *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).¹⁹

¹⁸ See *Peil v. Speiser*, No. 85-1360 (3d Cir. Nov. 28, 1986), slip op. 12-16; *Harris v. Union Electric Co.*, 787 F.2d 355, 367 & n.9 (8th Cir. 1986); *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), cert. denied, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) cert. denied, 459 U.S. 1102 (1983); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), vacated as moot after cert. granted, 459 U.S. 1027 (1982); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). See also, *Wachovia Bank & Trust Co. v. National Student Marketing Co.*, 650 F.2d 342, 358 (D.C. Cir. 1980), cert. denied, 452 U.S. 954 (1981); *In re LTV Securities Litigation*, 88 F.R.D. 134, 142 (N.D. Tex. 1980); *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982).

¹⁹ The court below stated that a defendant can rebut the presumption of reliance by showing (1) that an insufficient

b. There is no conflict on this issue in the lower courts.²⁰ Every court that has addressed the issue has sustained the fraud on the market theory (see note 18, *supra*), which rests on a valid chain of causation between the misrepresentation and the plaintiff's action. Furthermore, while the burden of proof in a fraud on the market case could be placed on the plaintiff, requiring him to prove his reliance on the integrity of the market price, every court applying the theory in the context (as in this case) of an active secondary market has also applied a presumption of reliance on the market price, recognizing that the overwhelming majority of traders *do* rely on market price in making investment decisions.²¹

number of traders relied on the misrepresentation to cause a distortion of the stock price or (2) that an individual plaintiff traded in spite of knowing the falsity of the representation or that he would have traded even if he had known the falsity (Pet. App. 18a n.6, citing *Blackie v. Barrack*, 524 F.2d at 906).

²⁰ Petitioners suggest (see Pet. 24-25) that there is a conflict in the circuits over the fraud on the market theory by citing the Second Circuit's decision in *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88 (1981). *Wilson v. Comtech* was not brought as a fraud on the market case and the theory is not discussed in the court's opinion; rather, the plaintiff attempted to establish a presumption of reliance on wholly different grounds. See *id.* at 93-94. The Second Circuit has adopted the fraud on the market theory in other cases (see note 18, *supra*).

²¹ See, e.g., *Peil v. Speiser*, *supra* at 15; *Lipton v. Documation, Inc.*, 734 F.2d at 742; *Panzirer v. Wolf*, 663 F.2d at 367; *Ross v. A.H. Robins Co.*, 607 F.2d at 553; *Blackie v. Barrack*, 524 F.2d at 906; *In re LTV Securities Litigation*, 88 F.R.D. at 143; *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. at 538.

Petitioners also suggest (Pet. 26-27), as an alternative position, that even if a presumption of reliance is appropri-

Nor is certiorari warranted, as petitioners contend (Pet. 27-28), to limit the potential abuse of class actions. Contrary to petitioners' assertion, the presumption of reliance in a fraud on the market case is grounded in characteristics of securities markets and investor behavior that are present in both class actions and individual actions. See *Blackie v. Barrack*, 524 F.2d at 988. The presumption is not applied to facilitate class actions in cases that would not otherwise be amenable to prosecution as class actions.²²

The presumption of reliance also is not, as petitioners contend (Pet. 22-26), an unwarranted extension of the Court's decision in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). The fraud on the market theory is not based on that case at all. In *Affiliated Ute*, the Court held that in Rule 10b-5 cases where a person in a relationship of trust fails to disclose material facts, "positive proof of reliance is not a prerequisite to recovery." 406 U.S. at 153. In this case the Sixth Circuit cited *Affiliated*

ate in a fraud on the market case brought by *purchasers*, it is inappropriate in a case, as here, brought by *sellers* of securities. They argue that, even assuming persons might make decisions to purchase securities in the open market based on the "relatively common basis" of market price, there is no reason to make the same assumption regarding decisions to sell, which might be made for a broader variety of reasons. But petitioners point to no authority for this distinction, and we suggest that it is not an appropriate issue for the Court to consider as a matter of first impression.

²² The district court in this case expressly disclaimed an intention of seeking to facilitate class actions (Pet. App. 129a). The court of appeals, while it noted that the presumption would facilitate the class action, did not state that that was a reason for invoking the presumption (*id.* at 16a-20a).

Ute as an illustration of another type of case where reliance may be presumed, but the court below did not ground its holding in *Affiliated Ute*. Indeed, the rationales for presuming reliance in the two types of cases are wholly different.²³ *Affiliated Ute* justifies a presumption of reliance because of the difficulties a plaintiff would face in affirmatively proving reliance on a nondisclosed fact of which he was unaware.²⁴ The fraud on the market theory presumes reliance because of assumptions about the efficient nature of secondary securities markets and actual investor reliance on the integrity of those markets.

²³ In *Blackie v. Barrack* the Ninth Circuit permitted a presumption of reliance under two distinct rationales: (1) that that case involved a failure to make a required disclosure, and (2) that the fraud on the market theory permitted such a presumption. The Ninth Circuit relied on *Affiliated Ute* only with respect to the first rationale; it drew no connection between *Affiliated Ute* and the fraud on the market theory. 524 F.2d at 906.

²⁴ See, e.g., *Chelsea Associates v. Rapanos*, 527 F.2d 1266, 1271 (6th Cir. 1975); *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 238-239 (2d Cir.), cert. denied, 423 U.S. 840 (1975); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 590 n.32 (1975).

CONCLUSION

The petition for a writ of certiorari should be granted limited to the first question presented.

Respectfully submitted.

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JOINT APPENDIX

No. 86-279

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust, and
RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

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Order of the Court of Appeals for the Sixth Circuit Denying Petition for Rehearing and Suggestion for Rehearing <i>en banc</i> , as amended	144a-146a
Order of this Court Extending Time to File Petition for Writ of Certiorari.....	147a
15 U.S.C. § 78j, Section 10(b).....	148a
17 C.F.R. § 240.10b-5, Rule 10b-5	148a
Rule 23, Fed.R.Civ.P.	149a

**CHRONOLOGICAL LIST OF
RELEVANT DOCKET ENTRIES**

District Court

- 6/18/79 COMPLAINT (CLASS ACTION) with JURY demand filed. Issued to U.S. Marshal.
- 9/12/79 MOTION OF DEFT., Basic, Inc. to dismiss with memorandum filed.
- 9/12/79 MOTION OF DEFTS., Caito, Eels, Jr., Gelbach, Lee Ludwig, Muller, Rose, Sylvester & Wilson; Jr. to dismiss w/memorandum
- 10/10/79 MEMORANDUM OF PLTFs. in opposition to Motions of Defts. to dismiss filed.
- 10/19/79 MINUTES OF PRE-TRIAL PROCEEDINGS FILED. Thomas, J. (Pltf. to file amended complaint w/in 2 wks).
- 10/25/79 ORDER THAT PLTF. shall file their amended complaint w/in 14 days of the date of this order and defts. shall answer or otherwise plead within 14 days of service of the amended complaint filed. Thomas, J. Issued (10/26/79).
- 10/26/79 TRANSCRIPT OF PROCEEDINGS before Judge Thomas on 10/19/79
- 11/8/79 AMENDED COMPLAINT filed.
- 12/3/79 MOTION of the individual defts. to dismiss the amended complaint with brief filed.
- 12/4/79 MOTION of deft., Basic Inc., to dismiss amended Complaint with memorandum and exhibits filed.
- 1/2/80 MEMORANDUM of pltf's. in opposition to motion of defts. to dismiss the amended complaint filed.
- 1/16/80 REPLY BRIEF of Individual defts. in support of motion to dismiss filed.
- 7/18/80 MEMORANDUM and ORDER Granting motion of individual defts. to dismiss Count II of the amended complaint filed. Thomas, J.

- 9/8/80 MOTION of Deft. Basic Inc. for reargument or for certification and to stay, with memorandum in support and exhibits in support filed.
- 9/8/80 MOTION of Individual Defts., for reconsideration of order denying motion to dismiss Count 1, or alternatively to amend such order to include findings, required by 28 U.S.C. Sec. 1292(b) & to stay proceedings, with memorandum in support filed.
- 9/16/80 MEMORANDUM of Pltfs., in opposition to Defts' motions to reargue, for certifications, pursuant to 28 U.S.C. § 1291(b) & for a stay of discovery, filed
- 10/14/80 MEMORANDUM & ORDER overruling individual defts' motion to dismiss; further order denying deft's request for certification for appeal under 28 U.S.C. § 1291(b); filed. Thomas, J.
- 10/17/80 ANSWER of individual defts. filed.
- 10/23/80 ANSWER of Deft., Basic Incorporated filed.
- 9/15/81 MOTION of Pltfs., to certify a class action, with memorandum in support affidavit & Exhibits in support filed.
- 11/12/81 MEMORANDUM of Defts., in opposition to Pltfs' motion to certify a class action filed.
- 12/1/81 REPLY memorandum of Pltfs., in support of Motion for class action certification filed.
- 12/11/81 MINUTES of Proceedings filed. Thomas, J. Lynn Orack Mizanin, r. (written ruling on class motion distributed—leave to file motion to reconsider must be made within 18 days response by 1/8/82—discovery—Court requires production of hand-written records for a period of 4 weeks, immediately surrounding statements issuance—In camera—Examination of SEC Transcript, telephone records, court finds no relevant material requiring disclosure)
- 12/10/81 MEMORANDUM & ORDER granting motion of Pltfs., for *class action certification* Pltf. may represent class members who sold after the 10/77 state-

- ment, he may also represent those selling after the 1978 statements, the period of time which he actually sold, pur. to R.23(a)(4) the Defts., also challenge the adequacy of Pltfs. Newman & Levinson to protect the interests of the class. It is concluded they have sufficient financial resources to meet costs of a (c) notice & other likely suit costs; it is concluded a class action is superior to other available methods for the fair & efficient adjudication of the controversy as required by Rule 23(b)(3) filed. Thomas, J.—copies issued. (noted 12/14/81)
- 12/29/81 MOTION of Defts. for reconsideration or for certification of an interlocutory appeal with memorandum in support, filed.
- 1/08/82 MEMORANDUM OF LAW by Pltf. in opposition to Deft's. motion for reconsideration and for certification of an interlocutory appeal, filed.
- 1/14/82 MOTION of Deft's. for leave to file reply memorandum, filed.
- 2/17/82 MEMORANDUM & ORDER that the Deft's. are correct that the time and money to be spent in trying this suit as a class action will have been expended unnecessarily if the Sixth Circuit were to conclude after trial that the substantive requirement of individual reliance need be shown in this case. An appeal of the issue at this point will avoid the unnecessary expenditure of time and resources and will "materially advance the ultimate termination of the litigation" by defining the burdens of proof existing as to all parties. The Court has the responsibility of balancing the interests of injured participants in the market against the potential of use of the class actions device to coerce settlement. Where, as here, a court's order affects a substantive element of a Rule 10b-5 cause of action, it is only fair to permit the parties affected to protect their interests by asserting their appeal rights at an early

stage. For the above stated reasons Deft's. motion to reconsider is denied, the class period previously defined is modified, and Deft's. motion for certification of an interlocutory appeal is granted, filed. Thomas, J.

- 1/15/82 REPLY MEMORANDUM of Deft's. in further support of motion for reconsideration or for certification of an interlocutory appeal, filed.
- 2/19/82 MEMORANDUM & ORDER the Court having filed its memorandum & order denying Deft's. motion to reconsider and granting Deft's. motion for certification of an interlocutory appeal, and the court having found therein: There is then a controlling question of law on which the Sixth Circuit has not ruled . . . and the court cannot say that there is no "substantial ground for difference of opinion." Therefore pursuant to 28 U.S.C. § 1291(b), the Court orders certification of the following questions (See order), Thomas J.
- 4/26/82 TRUE COPY of ORDER from the U.S.C.A. that upon receipt of the Deft's. petition to take an interlocutory appeal to this Court to 28 U.S.C. § 1292(b) and Rule 5, Federal Rules of Appellant Procedure, And upon consideration of the memoranda filed in support of and in opposition to such an appeal, IT is ordered that said motion be and it hereby is denied, filed. Hehman, John P., Clerk (4/26/82)
- 4/26/82 BRIEF in OPPOSITION by Pltf's. to Deft's. petition for permission to take an interlocutory appeal pursuant to 28 U.S.C. § 1291(b) and Rule 5, Federal Rules of Appellant Procedure with exhibits A-D, filed.
- 5/14/82 TRUE COPY OF MANDATE from the U.S.C.A. that upon the receipt of the Deft's. petition to take an interlocutory appeal to this Court pursuant to 28 U.S.C. § 1292(b) and Rule 5, Federal Rules of

Appellant Procedure, And upon consideration of the memoranda filed in support of and in opposition to such an appeal, It is ORDERED that said motion be and it hereby is denied, Brown, Martin and Jones, Circuit Judges; Issued as Mandate on 5/11/82.

- 6/4/82 DEPOSITION of Louis G. Kelly, filed.
- 10/26/82 MOTION of deft Caito, Eells, Jr., Gelbach, Lee, Ludwig, Muller, Rose, Sylvester and Wilson, Jr. for summary judgment of the individual defts, filed.
- 10/26/82 MOTION of deft Basic Inc. for summary judgment, filed.
- 10/26/82 MEMORANDUM OF LAW of deft Basic Inc. in support of motion for summary judgment, filed.
- 10/26/82 JOINT factual statements of defts, filed.
- 10/26/82 JOINT appendix of defts, filed.
- 1/21/83 PLTF's memorandum of law in opposition to defts motion for summary judgment
- 1/21/83 PLTF's exhibits in opposition to motion for summary judgment, filed. (Vols 1-6)
- 1/21/83 COPY of deposition of Theodore Thomas, filed. (1 vol.)
- 1/21/83 COPY of deposition of Joseph R. Perella and Preston Insley, filed. (1 vol.)
- 1/21/83 COPY of deposition of James Barton Kelly, filed. (1 vol.)
- 1/21/83 COPY of deposition of Anthony M. Caito, Arthur J. Santry, Jr. and John C. Wilson, filed. (1 vol.)
- 1/21/83 COPY of deposition of Theodore James Mayer, filed. (1 vol.)
- 1/21/83 COPY of deposition of Thomas James Mayer before the SEC, filed. (1 vol.)

- 1/21/83 COPY of deposition of David F. Dolan and H. Chapman Rose, filed. (1 vol)
- 1/21/83 COPY of deposition of Mathew Joseph Ludwig, filed. (2 vols)
- 1/21/83 COPY of deposition of James Barton Kelly, filed. (1 vol)
- 1/21/83 COPY of deposition of Geoffrey S. Parker, filed. (1 vol)
- 1/21/83 COPY of deposition of Max Muller, filed. (2 vols)
- 8/3/84 Memorandum and Order granting defendants' motions for summary judgment, filed.

Court of Appeals

- 8/28/84 Court of Appeals Notice of Appeal, filed; and cause docketed. (84-3730)
Certified Record (04 vol. pleadings, 01 vol. transcript, 04 vols. depositions, 10 vols. of separate pleadings #77, 78, 92, 107, 92A, 62, 63, 123, 126A, 161); filed [84-3730; 3775; 3776]
- 9/10/84 Notices of Appeal filed (84-3775/3776—consolidated for briefing and oral argument with 84-3730)
- 1/20/85 Appellants' brief filed (84-3775/3776)
- 2/19/85 Appellees' brief filed (84-3775/3776)
- 2/21/85 Appellants' brief filed
- 3/21/85 BRIEF of appellee (Basic) filed
- 3/21/85 BRIEF of individual appellees filed
- 4/5/85 REPLY BRIEF
- 4/10/85 JOINT APPENDIX (5) (Vol. I, II, III, IV, V) (84-3730/3775/3776)
- 10/8/85 ADDITIONAL CITATIONS submitted by the appellants
- 10/10/85 MOTION of SEC to file brief amicus curiae out of time (Motion Granted JPH/kmp per JST)

- 10/10/85 SEC amicus curiae BRIEF filed
- 10/15/85 ADDITIONAL CITATIONS submitted by appellants
- 10/28/85 MOTION: appellee to file supplemental brief in response to SEC brief (Motion Granted, J. Martin/kmp)
- 11/1/85 SUPPLEMENTAL BRIEF of appellee filed
- 12/6/85 CAUSE argued by Cross for appellant, by Sternman for appellee and case submitted to the Court (Before: Martin, Jones and Wellford, JJ.)
- 3/27/86 JUDGMENT of the District Court is affirmed in part, reversed in part and remanded for further proceedings, each party to bear its own costs (Martin, Jones and Wellford, JJ.)
- 4/23/86 PETITION FOR REHEARING EN BANC filed by appellees
- 5/16/86 RESPONSE of appellants in opposition to petition for rehearing and suggestion for rehearing en banc
- 6/19/86 ORDER: petition for rehearing en banc denied (Martin, Jones and Wellford, JJ.)
- 6/25/86 MOTION appellees to stay mandate pending petition for writ of certiorari with the Supreme Court
- 7/2/86 ORDER: amending the Court's 6/19/86 order denying the petition for rehearing en banc to include Judge Wellford's concurrence in part and dissent in part (Martin, J.)
- 7/2/86 RESPONSE of appellant in opposition to appellee motion to stay mandate
- 7/8/86 ORDER: Mandate stayed pending certiorari (Martin, J.)
- 8/23/86 NOTICE and certificate of filing petition for certiorari (S. Ct. No. 86-279)

ADDITIONAL REGULATORY PROVISION INVOLVED

FEDERAL RULES OF CIVIL PROCEDURE

RULE 56. Summary Judgment

(a) *For Claimant.* A party seeking to recover upon a claim, counterclaim, or cross-claim or to obtain a declaratory judgment may, at any time after the expiration of 20 days from the commencement of the action or after service of a motion for summary judgment by the adverse party, move with or without supporting affidavits for a summary judgment in his favor upon all or any part thereof.

(b) *For Defending Party.* A party against whom a claim, counterclaim, or cross-claim is asserted or a declaratory judgment is sought may, at any time, move with or without supporting affidavits for a summary judgment in his favor to all or any part thereof.

(c) *Motion and Proceedings Thereon.* The motion shall be served at least 10 days before the time fixed for the hearing. The adverse party prior to the day of hearing may serve opposing affidavits. The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. A summary judgment, interlocutory in character, may be rendered on the issue of liability alone although there is a genuine issue as to the amount of damages.

(d) *Case Not Fully Adjudicated on Motion.* If on motion under this rule judgment is not rendered upon the whole case or for all the relief asked and a trial is necessary, the court at the hearing of the motion, by examining the pleadings and the evidence before it and by interrogating counsel, shall if practicable ascertain what material facts exist without substantial controversy and what material facts are actually and in good faith controverted. It shall thereupon make an order specifying the facts that appear without substantial controversy, including the extent to which the amount of damages or other relief is not in controversy, and directing such further proceedings in the action

as are just. Upon the trial of the action the facts so specified shall be deemed established, and the trial shall be conducted accordingly.

(e) *Form of Affidavits: Further Testimony; Defense Required.* Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith. The court may permit affidavits to be supplemented or opposed by depositions, answers to interrogatories, or further affidavits. When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him.

(f) *When Affidavits are Unavailable.* Should it appear from the affidavits of a party opposing the motion that he cannot for reasons stated present by affidavit facts essential to justify his opposition, the court may refuse the application for judgment or may order a continuance to permit affidavits to be obtained or depositions to be taken or discovery to be had or may make such other order as is just.

(g) *Affidavits Made in Bad Faith.* Should it appear to the satisfaction of the court at any time that any of the affidavits presented pursuant to this rule are presented in bad faith or solely for the purpose of delay, the court shall forthwith order the party employing them to pay to the other party the amount of the reasonable expenses which the filing of the affidavits caused him to incur, including reasonable attorney's fees, and any offending party or attorney may be adjudged guilty of contempt. (As amended Dec. 27, 1946, eff. Mar. 19, 1948; Jan. 21, 1963, eff. July 1, 1963.)

**EXCERPTS FROM DEPOSITION TRANSCRIPTS
AND TRANSCRIPTS OF SEC TESTIMONY**

**Excerpt from the deposition of Edwin P. Arnolt
by Respondents**

[66] * * * * Q. What was your understanding of the purpose of Mr. Insley's visit to Cleveland? A. In very general terms, I think Basic was interested in their activity, in the refractories area particularly, and we decided to exchange information on a relative position of their business in the refractories and ours. * * * *

**Excerpts from the deposition of Anthony M. Caito
by Respondents**

[77] * * * * Q. Do you recall discussing the possibility of some form of acquisition of Combustion's [78] refractories division inside Basic following Mr. Insley's meeting? A. Yes.

Q. On how many occasions? A. I can't give you the exact number.

Q. More than one? A. It might have been several times, two or three.

Q. Did you discuss how much you should offer? A. No.

Q. At any time? A. I did not, no.

Q. Were you consulted as to how much should be offered? A. No. * * * *

[97] * * * * Q. Who is Mr. Steinhouse? A. Counsel with Jones, Day.

Q. He's a lawyer with Jones, Day? A. Yes.

Q. Do you recall a discussion about having Steinhouse look at U. S. Gypsum versus Basic? A. Yes.

Q. Do you recall what the purpose of that evaluation was? A. Antitrust.

Q. Was there a possibility that U.S. Gypsum was going to acquire Basic? A. I knew they were interested in Basic.

Q. How did you know that? A. From Mr. Muller.

Q. Was that discussed with Mr. Rose in his office? A. I don't recall.

Q. What specifically do you recall Mr. Steinhouse was going to do in terms of evaluating the product lines?

A. From an antitrust standpoint, whether there was a problem with our product lines in terms of antitrust.

[102] Q. Following your meeting in Mr. Rose's office on June 16, 1978, what if anything did you do next with respect to the discussions with Combustion? A. I did nothing that I recall.

Q. You had been assigned at that meeting to assist Mr. Steinhouse in an antitrust review, isn't that right? A. Yes.

Q. What did you do to follow up that assignment? A. I obtained information on product categories and sales by SIC numbers.

Q. SIC is Standard Industrial Code? A. Right.

Q. Do you recall how many SIC numbers there were? A. There was quite a listing of SIC numbers for Combustion product lines.

Q. What about for Basic's product lines? A. I think there were three that were [103] products that would be overlapping.

Q. Do you recall requesting Mr. Muller to get Combustion's data with respect to those three SIC numbers? A. I did not request it.

Q. Did you provide the Basic data to Mr. Steinhouse? A. Yes.

Q. Do you recall when you did that? A. The exact point in time, no.

Q. Let me show you a document that has previously been marked as Plaintiff's Exhibit 92. Plaintiff's Exhibit 92 is really two letters, one is dated July 21 and the other is dated June 21, which is an attachment to the July 21 letter.

Can you review those two letters and tell me whether or not you recall writing them to Mr. Steinhouse? A. Yes, I remember writing these.

Q. First of all, is the handwriting on either of those letters yours? A. This is not mine (indicating).

Q. Pointing to page one of the July 21 letter where it says MM. [104] Do you know whose handwriting that is? A. It's Mr. Muller's.

Q. What about on page two? A. This is not mine (indicating).

Q. The part that says non-Basic? A. Yes.

Q. What about on the schedules of the June 21st letter? A. No, that is not mine (indicating).

Q. Pointing to the last page of the exhibit? A. Yes.

Q. The second paragraph of the June 21st letter indicates that Table I attached to the letter represents products which are marketed by CE refractories.

What was the basis of your understanding as to what products CE refractories did market? A. The Refractory Institute directory that lists products made by all refractory companies.

Q. Had you received, prior to this time, any information from CE about its refractories products? A. No. I myself went through the Refractory [105] Institute listings and picked out the SIC numbers and products that were listed under CE refractories and compiled a list myself by using the Refractory Institute data.

Q. Did you do that before or after the meeting on June 16th in Mr. Rose's office? A. After.

Q. And before June 21st? A. Yes.

Q. It says here that, from the total of the products marketed by CE refractories, you have subtracted out two SIC codes, and the two numbers set forth are 3297065 and 3297071.

What was the basis for subtracting those two SIC codes out of Combustion's data? A. I separated out the CE products into—subtracted out the Basic types where there are SIC numbers.

Q. Prior to preparing the table and sending it to Mr. Steinhouse, did you have any conversation with him regarding what kind of information he needed? A. Only to give a detail of the products and classifications so that market share could be calculated.

[106] Q. Did he give you some idea as to what kind of market share he might need to calculate; did he provide some basis on which you took Basic type products out of your calculations? A. No, I provided the basis by SIC numbers.

Q. You comment on there that you've eliminated from the numbers those two SIC codes.

Why did you do that? Why didn't you give him all the raw data? A. To separate the CE products that were not competitive with Basic as opposed to those that could be, and the ones that could be were the Basic type products, to give him a breakdown of their total sales in those two categories.

Q. Had you discussed with him the concept of which products were competitive and which products overlapped? A. No. I made that decision.

Q. Had you done any analysis like that prior to the June 16th meeting? A. No.

Q. Had you discussed with anybody at Jones, Day anti-trust implications prior to the June [107] 16th meeting?

MR. STERNMAN: Of CE?

MR. CROSS: Of any form of combination with CE.

A. No.

Q. Do you recall the topic ever coming up prior to the June 16th, 1978 meeting? A. No.

Q. The fourth paragraph on page one of the June 21st letter indicates, "As I mentioned in our previous meeting, Combustion Engineering also has a refractory division entitled CE minerals."

What meeting are you referring to in that sentence? A. That was a meeting with Carl and I.

Q. Just the two of you? A. Just the two of us.

Q. Do you recall when that meeting took place? A. No, not an exact point in time.

Q. It was after the June 16th meeting? A. Yes.

Q. Do you recall what you discussed in that meeting? [108] A. What data he wanted prepared.

Q. So you did get some direction from Mr. Steinhouse as to what data to prepare? A. Not by products. That decision was left to me.

Q. As to which products, I understand that, but did he give you general parameters as to the kind of data he needed, the kind of concern he had for antitrust purposes?

MR. MADSEN: Object to the form.

A. What markets we served that would be common for both refractory companies.

Q. Do you recall, did you meet with Steinhouse the same day that you met with Mr. Rose? A. No.

Q. I mean, you were in the Jones, Day offices? A. I don't recall the exact date.

Q. Did Mr. Steinhouse join the meeting in Mr. Rose's office? A. No, not that I recall.

Q. Had you ever meet Mr. Steinhouse before? A. Yes.

[111] Q. Other than on that occasion, had you had any contact with Mr. Steinhouse? A. The other contact involved A. P. Greene, and I assembled some data for him on A. P. Greene and Basic. * * * *

[148] Q. Let me show you a document that's been marked as Plaintiff's Exhibit 64 and ask you if you recall seeing that before? A. Yes, I remember it.

Q. Do you remember seeing it at or about the time that it was sent out? A. I saw it at the time.

Q. Did you see it before it went out? A. No.

Q. Did you participate in any discussions about the necessity for sending out a news release? A. No, did I not.

Q. Did you know the New York Stock Exchange had made an inquiry? A. No.

Q. Following seeing this press release, did you talk to anybody about the press release? A. Not that I recall.

Q. Even to mention it? A. No, not that I recall.

[154] * * * * Q. Let me show you what has been marked as Plaintiff's Exhibit 65, which is a copy of the quarterly report for the period ended September 30, 1978.

Have you seen that document before? A. Yes.

Q. Did you review it before it was sent out? A. No.

Q. Did you see it before it was sent out? A. No.

Q. As director of the company, are you not given those documents to review before they go out? A. No.

Q. Did you review it after it went out? A. I saw it after it was issued, yes.

Q. Did you discuss it with anyone? A. No.

Q. Did you receive a copy of that document, [155] I mean, in the mail, as a shareholder? A. Yes.

Q. Do you recall when you received it? A. The exact date, at the house, no, I don't.

Q. On the date that Plaintiff's Exhibit 65 was issued, were you aware that there had been discussions with Combustion about a merger?

MR. MADSEN: You mean did he have that in his mind that day?

MR. CROSS: Was he aware on that day. I don't know whether he had it in his mind.

MR. MADSEN: He's asking you if you remember being aware on whatever date this is.

MR. CROSS: No, that's not the question I'm asking. I'm asking, did he have the knowledge that there had been prior discussions with Combustion on that day.

MR. STERNMAN: Well, that's been asked and answered. There has been a lot of testimony about discussions that he was aware of prior to November, 1978, and if all you're asking is had discussions * * * *

[210] Q. You did discuss that? A. Yes.

Q. What did you discuss? A. What I have reference to is a meeting in Mr. Rose's office, the meeting in Mr. Rose's office when he advised that we should stay out of the market.

Q. When was that meeting? A. The date was pinpointed yesterday.

Q. The June 16th meeting? A. The meeting in Mr. Rose's office.

Q. The meeting following the Kelly visit where you and Mr. Muller and Mr. Ludwig met with Mr. Rose and you were assigned to work with Mr. Steinhouse? A. Yes.

Q. And Mr. Rose said stay out of the market? A. Yes.

Q. What else did he say at that time? A. That was all that I recall.

Q. Did he express a reason for why you should stay out of the market? A. No.

Q. Did you stay out of the market thereafter?

MR. MADSEN: You're asking [211] him personally?

MR. CROSS: Yes, him personally. A. Yes.

Q. Do you personally know whether any other employees of Basic traded in Basic securities following that meeting? A. I do not know.

Q. Did all the members of your family stay out of the market? A. Yes.

Q. Did you exercise any stock options after that meeting? A. Yes.

MR. MADSEN: Is your question related to the period prior to December 18, 1978?

MR. CROSS: Yes.

Q. Did you exercise any stock options during the period June 16, 1978 to December 18, 1978? A. Yes.

Q. Do you recall how many, for how many shares? A. No, don't recall the exact shares.

Q. Why did you exercise those options at [212] that time? A. Two reasons.

Q. What were the two reasons? A. One, I had dollars available, and secondly, to start the time period for options.

Q. I don't understand that.

Can you explain, what is the time period for options? A. The difference between the taxes for the holding period.

Q. I still don't understand that. I'm not a tax lawyer.

What time period was relevant for tax consequences? A. There is a three year holding period on short term versus long term. * * * *

**Excerpts from the deposition of David Dolan
by Respondents**

[24] * * * * Q. Mr. Dolan, have you seen Plaintiffs' Exhibit 2 before? A. Yes, I have.

Q. Could you identify the document? A. It is an Exchange publication entitled "Expanded Policy on Timely Disclosure." * * * *

Q. Does this document set forth the standards [25] adopted by the New York Stock Exchange? A. Yes, it does.

Q. In effect, during the period 1976 through December 1978? A. That's correct.

Q. Did your responsibilities as liaison representative for the midwestern region include the responsibility for the familiarity with this document?

MR. STERNMAN: Read back the question.

(Record read.)

A. Yes, it did.

Q. Did it include responsibilities for assuring compliance with the standards set forth in this document by public corporations listed on the New York Stock Exchange? A. Yes, it did.

Q. You mentioned a few moments ago that this is a document that is published? A. Yes, that's correct.

Q. In what form is it published? A. It is a booklet published by the New York Stock Exchange.

Q. Published and made available to the management of companies that were listed on the New York [26] Stock Exchange? A. Yes, it is.

Q. Basic Incorporated was one of those companies?

MR. STERNMAN: I am going to object to that question. You mean one of the companies it was made available to or a company listed on the New York Stock Exchange?

Q. Basic Incorporated was one of the companies listed in the New York Stock Exchange? A. Yes, it was.

Q. Do you see the statement on the bottom left-hand page which says, "Reprinted from the New York Stock Exchange Company manual"? A. Yes, I do.

Q. Can you tell me what that refers to? A. It means that this publication is reprinted from the New York Stock Exchange company manual.

Q. What is the New York Stock Exchange company manual, if you would, sir? A. It is a compilation of the rules and regulations and guidelines of the New York Stock Exchange as it would apply to corporations whose shares are listed on the Stock Exchange.

Q. Including Basic Incorporated?

[27] A. Including Basic Incorporated.

Q. These are reprinted in a manual, is that correct? A. That's correct. There are several different excerpts that are reprinted in various forms.

Q. That is a public manual? A. That's correct.

Q. Do you know whether the management of Basic Incorporated had a copy of that manual? A. Yes, they did.

Q. How do you know that? A. All corporations whose shares are listed on the Stock Exchange are automatically given one copy of the New York Stock Exchange company manual.
• • • • •

[28] • • • • • Q. Mr. Dolan, did the New York Stock Exchange as a matter of practice provide the majority of corporations listed on the New York Stock Exchange with a copy of

the New York Stock Exchange company manual? A. Yes, it did.

Q. Which included the expanded policy on timely disclosure? A. Yes, it did.

Q. Did the New York Stock Exchange also provide the management of corporations listed on the New York Stock Exchange with any amendments to the company manual? A. As a matter of practice it did.

Q. Did you ever have occasion to talk with the management of Basic Incorporated about any of the provisions of the New York Stock Exchange company manual? A. I can't recall any specific instances.

Q. Plaintiffs' Dolan Exhibit 2 is entitled "Expanded Policy on Timely Disclosure." You testified earlier, I believe, that this represents standards adopted by the New York Stock Exchange; is that correct? [29] A. That's correct.

Q. Are these standards adopted by a governing body of the New York Stock Exchange? • • • • • A. I don't know the particular body within the New York Stock Exchange that originally formulated the company manual.

Q. Is there a body within the New York Stock Exchange that promulgates and adopts standards such as these? A. There are various constituents within the Stock Exchange that review and implement Exchange policies and have them approved by a proper governing body.

Q. What do you mean by constituents? A. Depending upon the particular areas within the company manual there might be different individuals who would formulate and develop Stock Exchange policies.

Q. Then that policy is adopted by some body? A. That's correct.

Q. What body is that, if you know? A. It's the board of directors of the New York [30] Stock Exchange.

Q. What is the purpose of the expanded policy on timely disclosure? • • • • •

• • • • • Q. You may answer the question, sir. A. The purpose of the expanded policy on timely disclosure is an emphasis of the portion of the New York Stock Exchange manual that addresses itself to timely disclosure.

Q. Is it one of the purposes of the expanded policy on timely disclosure to show that a corporation listed on the New York Stock Exchange will promptly release to the general public any news or information which might reasonably be expected to affect the market for its securities? * * * *

[31] * * * * Q. Could you describe for me, please, Mr. Dolan, the purpose of the expanded policy on timely disclosure? A. The New York Stock Exchange Company manual that addresses itself in a particular section to timely disclosure is reprinted in this booklet entitled "Expanded Policy of Timely Disclosure," to serve as a reminder—to serve as an emphasis to listed corporations of their obligation to notify the Stock Exchange of particular matters that would require timely disclosure.

Q. Let me direct your attention to your affidavit to the Securities and Exchange Commission, specifically to paragraph 4. * * * *

[32] * * * * Q. Mr. Dolan, did you read this affidavit before executing it? [33] A. Yes, I did.

MR. SIMPLICIO: Mr. Elkind, I think you were asking Mr. Dolan a question prior to Mr. Sternman's objection. Do you want him to answer that question?

MR. ELKIND: Yes, I will get to it.

Q. Did you execute this affidavit under oath certifying at the end that the affidavit is true and correct? A. Oh, yes, I did. Yes.

Q. Is this affidavit true and correct, to the best of your knowledge? A. Yes, it is.

Q. Is there anything in this affidavit that is incorrect? A. No, there is not.

Q. Did you swear to this affidavit under oath as an official of the New York Stock Exchange? A. Yes, I did.

MR. STERNMAN: May I ask a few questions about the affidavit?

MR. ELKIND: On cross-examination you can ask the witness whatever you like.

Q. Let me direct your attention to paragraph 4 of [34] the affidavit, Mr. Dolan, which says, and I quote—

MR. STERNMAN: I move to strike any testimony which you elicit until you permit me the opportunity to ask a few questions of Mr. Dolan about the preparation of this affidavit.

Q. Let me direct your attention to paragraph 4: "It is New York Stock Exchange policy that a corporation, the stock of which is listed on the New York Stock Exchange, is expected to appropriately release to the public any news or information which might reasonably be expected to materially affect the markets for its securities. This policy is more fully set forth in the New York Stock Exchange's expanded policy on timely disclosure," Exhibit A.

Is that statement truthful and accurate? * * * *

* * * * Q. Is that statement truthful and accurate, Mr. Dolan? A. Yes, it is.

[35] Q. Is it one of the purposes of the New York Stock Exchange's expanded policy on timely disclosure to assure that a corporation listed on the New York Stock Exchange will appropriately release to the public any news or information which might reasonably be expected to materially affect the market for its security? * * * *

* * * * Q. Mr. Dolan, let me direct your attention again to the affidavit which has been marked as Plaintiffs' Dolan Exhibit 1. Was that affidavit reviewed by you before you executed it?

MR. STERNMAN: Objection. It has [36] already been asked and answered.

A. Yes, it was.

Q. Did you review it for accuracy and truthfulness? A. Yes, I did.

Q. Did you determine that it was accurate and truthful in all respects before you executed it? A. Yes, I did.

Q. What were the sources of the information contained in the affidavit? A. The sources of the information were the policy, expanded policy on timely disclosure, as well as the

other forms, notably stock watch forms which we refer to as kickout forms that pertain to the matter described within this affidavit.

Q. Are you referring to the documents that are attached as Exhibits A through F of the affidavit? A. Yes, I am.

Q. Do you know who actually prepared this affidavit? A. I don't know the gentleman's name, no. It was prepared by some individuals representing the SEC who were present at the time that I gave the affidavit. It was comments and, well, I guess, relating to investments that I gave to them during a particular period of time. [37] So, in essence, they were writing up what I had told them and I agree that this is truthful and accurate. • • • •

• • • • Q. Mr. Dolan, is this affidavit an accurate recollection of the events recited therein? A. Yes, it is.

Q. Is this affidavit a reflection of information [38] given by you to the SEC? A. Yes, it is.

Q. Is it based entirely on the information given by you to the SEC? A. Yes, it is.

Q. Did you meet with representatives of the SEC? A. Yes, I did.

Q. Did they interview you? A. Yes, they did.

MR. STERNMAN: Why don't you listen to the questions rather than answering so quickly, if you would, because, possibly I could make an objection. It sounds as if no matter what Mr. Elkind asks you you are going to say yes.

THE WITNESS: Despite what it sounds like, I hear them clearly.

MR. STERNMAN: If you could pause one second before answering—in case I have an objection, I would like to make it.

Q. Has your testimony thus far in this case been truthful and accurate? A. Yes.

Q. You met with representatives of the SEC? A. Yes, I did.

[39] Q. You provided them with information? • • • •

• • • • Q. Could you describe for me in your own words, please, Mr. Dolan, how this affidavit was prepared? A. It was prepared as a result of testimony that I had given to representatives of the SEC.

Q. Did you give a deposition to the SEC? A. I gave an oral deposition, yes.

Q. Was it transcribed by a court reporter? A. No, it was not.

Q. Please continue as to the preparation of this affidavit. A. During my testimony one of the representatives of the SEC had taken notes as to what testimony I had given and it related entirely to my involvement in investments trading activity of Basic Incorporated [40] during this period of time.

Q. Did you then review this affidavit for accuracy? A. Yes, I did.

Q. Did you determine that it was accurate? A. Yes, I did.

Q. Is it in any respect inaccurate? A. It was not.

Q. Would you as an official of the New York Stock Exchange sign an affidavit under oath that was in any respect inaccurate? • • • •

• • • • A. I signed this document knowing full well that it was the testimony that I had given and it was truthful [41] and accurate to the best of my knowledge. • • • •

• • • • Q. Mr. Dolan, previously you discussed the expanded policy on timely disclosure that was reprinted from the New York Stock Exchange company manual. A. Yes.

Q. I would like to show you a copy of certain sections of the New York Stock Exchange company manual which has previously been marked in this case as Plaintiffs' Exhibit 66. Take a few moments to look at it, sir.

MR. ELKIND: Why don't we mark Plaintiffs' Thomas Exhibit 66 once again as Plaintiffs' Dolan Exhibit 3, please.

(Above-referred-to document marked Plaintiffs' Exhibit Dolan 3 for identification, as of this date.)

MR. STERNMAN: Let's take a break.

[42] (Recess taken.)

MR. ELKIND: Off the record.

(Discussion off the record.)

Q. Mr. Dolan, could you identify Plaintiffs' Dolan Exhibit 3, please? A. Yes, this is Section A2 of the New York Stock Exchange company manual that pertains to the timely disclosure of material news announcements by the companies whose shares are on the Stock Exchange, procedure for public release of that information and other sections relating to the listing agreement or the committee conflicts of interest and defensive tactics.

Q. Are these standards that are adopted by the New York Stock Exchange? A. Yes, they are. This is a portion of the New York Stock Exchange company manual.

Q. Is that the company manual to which you previously referred? A. Yes, it is.

Q. That is published? A. That's correct.

Q. And that is provided to the management of corporations listed on the New York Stock Exchange? A. That's correct.

[43] Q. Do the provisions in Plaintiffs' Dolan Exhibit 3 represent standards adopted by the New York Stock Exchange? A. Yes, it does.

Q. Let me direct your attention to the page of the exhibit that is numbered A-18. Let me direct your attention specifically to the section entitled "Section A12, Part 1, Timely Disclosure," and is then entitled "Timely and Adequate Disclosure of Corporate News."

Let me ask you to read the first two paragraphs of that section, if you would, and I will ask the reporter to print those paragraphs in the record while you are reading them.

"A corporation whose securities are listed on the New York Stock Exchange, Inc. is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for those securities. This is one of the most important and fundamental purposes of the listing agreement which each corporation enters into with the Exchange. The agreement is discussed in greater detail in the latter part of this section beginning on page A-32."

"A corporation should also act promptly to dispel unfounded rumors which result in unusual market activity or price variations."

[44] Have you had an opportunity to read the first two paragraphs, Mr. Dolan? A. Yes, I did.

Q. Do those paragraphs represent standards adopted by the New York Stock Exchange? A. Yes, they do.

Q. For public corporations listed on the New York Stock Exchange? A. Yes, they do.

Q. Including Basic Incorporated? A. Yes.

Q. Those standards are included in this, the company, New York Stock Exchange company manual? A. Yes, they are.

Q. Up at the top right-hand corner of the page is the date 8/1/77. Can you tell me if you know what that refers to? A. That would be the date of the last revision of this particular section.

Q. So this section was effective as of August 1, 1977; is that right? A. That was the date of the last revision of this section.

MR. STERNMAN: I am going to move to strike [45] it. I don't see, unless Mr. Dolan knows it from his independent recollection, that he could tell that that section has not been revised to date, if that is what he means. I understood that to be the date that this particular revision was made, or are you saying that that has not been revised at all in the last five years.

MR. ELKIND: That is not what I have asked the witness.

MR. STERNMAN: His testimony is that this is the last revision. That seems to me that this is the revision that has been duplicated. It was in effect at least as of August 1, 1977.

Q. Was this provision in effect as of August 1, 1977? A. Yes, it was.

Q. Are you aware of any revisions of this provision during the period August 1, 1977 through December 20, 1978? A. No, I am not.

Q. Can you tell me whether this provision was also in effect prior to August 1, of 1977?

MR. STERNMAN: I am going to object. That is beyond the class period. I don't see [46] what relevance it has at all.

Q. Let me show you the expanded policy on timely disclosure which was previously marked as Plaintiffs' Dolan Exhibit 2. Do you see the dates on the upper right-hand portions of the pages on the right-hand side? A. Yes, I do.

Q. Do those dates refer to the effective dates of those provisions? A. Yes, they do.

MR. STERNMAN: Let me move to strike that answer. Mr. Dolan has referred to a date which was 1968, some eight years before he was associated with the New York Stock Exchange. I don't understand how he could be testifying as to what a date on a document such as that refers to since he was not with the Exchange when that document was prepared. It may seem logical to you, Mr. Dolan, but I don't think under your own knowledge under oath you can state what that date is.

Q. Let me direct your attention, Mr. Dolan, to page A-19 of the New York Stock Exchange company manual which has been marked as Plaintiffs' Dolan Exhibit 3 and let me ask you to read the second paragraph under the [47] heading "Internal Handling of Confidential Corporate Matters," which begins, "Negotiations leading to acquisitions and mergers," et cetera.

Let me ask you to read that paragraph yourself, and I ask the reporter to put it into the record at the same time.

"Negotiations leading to acquisitions and mergers, stock splits, the making of arrangements preparatory to an exchange or tender offer, changes in dividend rates or earnings, calls for redemption, new contracts, products or discoveries are the type of investments where the risk of untimely and inadvertent disclosure of corporate plans is most likely to occur. Frequently, these matters require discussion and study by corporate officials before final decisions can be made. Accordingly,

extreme care must be used in order to keep the information on a confidential basis."

MR. ELKIND: Let me also ask you to read the next paragraph on page A-20, which begins, "Where it is possible," and I will ask the reporter to put that into the record.

"Where it is possible to confine formal or informal discussions to a small group of the top management of the company or companies involved, and their [48] individual confidential advisers where adequate security can be maintained, premature public announcement may be properly avoided. In this regard, the market action of a company's securities should be closely watched at a time when consideration is being given to important corporate matters. If unusual market activity should arise, the company should be prepared to make an immediate public announcement of the matter."

Q. Do those two paragraphs represent standards adopted by the New York Stock Exchange? A. Yes, they do.

Q. They are applicable to public corporations listed on the Exchange? A. That's correct.

Q. Including Basic Incorporated? A. That's right.

Q. Included in the public New York Stock Exchange company manual? A. That's right.

Q. Were those provisions effective as of August 1, 1977? A. Yes, they were.

Q. Were they in effect during the period 1977 through December 1978? [49] A. Yes, they were.

Q. Let me ask you to read the next paragraph, which begins, "At some point it." I will ask the reporter to put that paragraph into the record. A. "At some point it usually becomes necessary to involve other persons to conduct preliminary studies or assist in other preparations for contemplated transactions, e.g., business appraisals, tentative financing arrangements, attitude of large outside holders, availability of major blocks of stock, engineering studies, market analysis and surveys, et cetera. Experience has shown that maintaining

security at this point is virtually impossible. Accordingly, fairness requires that the company make an immediate public announcement as soon as confidential disclosures relating to such important matters are made to outsiders."

Q. Does that paragraph represent standards adopted by the New York Stock Exchange? A. Yes, it does.

Q. Applicable to public corporations listed on the Exchange? A. Yes, it does.

Q. Including Basic Incorporated? [50] A. Yes.

Q. And it is included in the public company manual? A. That's right.

Q. That provision was in effect as of August 1, 1977 through December 20, 1978? A. That's correct.

Q. Let me ask you to read the following paragraph which begins, "The extent of the disclosures," and I will request the reporter to put that into the record. A. "The extent of the disclosures will depend upon the stage of discussion, studies and negotiations. So far as possible, public statements should be definite as to price ration, timing and/or any other pertinent information necessary to permit a reasonable evaluation of the matter. As a minimum, they should include those disclosures made to 'outsiders.' Where an initial announcement cannot be specific or complete, it will need to be supplemented from time to time as more definite or different terms are discussed or determined."

Q. Does that paragraph represent standards adopted by the New York Stock Exchange? A. Yes, it does.

Q. Applicable to public corporations listed on the [51] Exchange? A. Yes, it does.

Q. Including Basic Incorporated? A. Yes, it does.

Q. Were those standards in effect during the period from August 1977 through December 20, 1978? A. Yes.

Q. This is also part of the New York Stock Exchange company manual, is it not? A. Yes, it is.

Q. Which is provided to the management of public corporations listed on the New York Stock Exchange? A. Yes. Yes, it is.

Q. Let me ask you to read the next paragraph, if you would, sir, which begins, "Corporate employees, as well as directors and officers should be regularly reminded as a matter of policy that they must not disclose confidential information they may receive in the course of their duties and must not attempt to take advantage of such information for themselves."

MR. ELKIND: I will ask the reporter to put that paragraph into the record.

Q. Have you had an opportunity to read that paragraph, sir? [52] A. Yes, I did.

Q. Does that represent standards adopted by the New York Stock Exchange? A. Yes, it does.

Q. Applicable to public corporations listed on the New York Stock Exchange? A. Yes, it does.

Q. Including Basic Incorporated? A. Yes.

Q. Were those standards in effect during the period August 1, 1977 through December 20, 1978? A. Yes.

Q. Let me ask you to read the next paragraph, which begins, "In view of," and I will ask the reporter to put that paragraph into the record. A. "In view of the response of this matter and the potential differences involved, the Exchange suggests that a periodic review be made by each company of the manner in which confidential information is being handled within its own organization. A reminder notice of the company's policy to those in sensitive areas might also be helpful from time to time."

Q. Have you had an opportunity to read that paragraph, Mr. Dolan? [53] A. Yes, I did.

Q. Does that represent standards adopted by the New York Stock Exchange? A. Yes, it does.

Q. Applicable to public corporations? A. Yes.

Q. Including Basic Incorporated? A. Yes.

Q. Were those standards in effect during the period August 1, 1977 through December 20, 1978? A. Yes, it was.

Q. Let me direct your attention to page A-21 of Plaintiffs' Dolan Exhibit 3. Beneath the heading entitled "Relationship Between Company Officials and Security Analysts, Institu-

tional Investors," et cetera, let me ask you to read the paragraph beginning, "A company should not give information to one inquirer which it would not give to another," going down through the last paragraph in that section which ends with the words, "in the marketplace."

I will ask the reporter to put that into the record while you read it.

"A company should not give information to one inquirer which it would not give to another. Nor should [54] it reveal information it would not willingly give to the press for publication. Thus, for corporations to give advance earnings, dividends, stock split, merger or tender information to analysts, whether representing institutions, brokerage houses, investment advisors or large stockholders, or anyone else would be clearly incompatible with the Exchange policy.

"On the other hand, it should not withhold information in which analysts or other members of the investing public have a warrantable interest. If, during the course of a discussion with analysts substantive material not previously published is disclosed, that material should be simultaneously released to the public."

"The various security analysts societies usually have a regular procedure to be followed where formal presentations are made. The company should follow these same precautions when dealing with groups of industry analysts in small or closed meetings. The competent analyst depends upon his professional skills and broad industry knowledge in making his evaluations and preparing his reports and does not need the type of inside information that could lead to unfairness in the marketplace."

Do those paragraphs represent standards adopted [55] by the New York Stock Exchange? A. Yes, they do.

Q. Applicable to public corporations listed on the Exchange? A. Yes, they do.

Q. Including Basic Incorporated? A. That's correct.

Q. Were those provisions in effect during the period of August 1, 1977 through December 20, 1978? A. Yes, they were.

Q. Let me direct your attention, Mr. Dolan, to the paragraph on page A-23 entitled "Dealing With Rumors or Unusual Market Activity: The market action of a corporation's securities should be closely watched at a time."

You see at the top left-hand portion of the page appears the date 10/25/78? A. Yes.

Q. Can you tell me what that date refers to? A. That was the date in which this particular portion of the company manual was in effect.

Q. The first of the effective date? A. That's correct.

Q. And prior to that were there similar provisions [56] that were in effect? A. They, there were.

Q. Are those represented by the expanded policy on timely disclosure which has been marked as Plaintiffs' Dolan Exhibit 2? A. Yes.

MR. STERNMAN: Can you identify for us where the comparable portion is on Exhibit 2, Mr. Dolan?

MR. ELKIND: It is hard to see the page number because it didn't fully xerox, but I think if you look on the fifth page of the exhibit you will see the comparable section in the policy on timely disclosure.

Q. Let me direct your attention, Mr. Dolan, to Plaintiffs' Dolan Exhibit 2, the paragraph entitled "Dealing With Rumors or Unusual Market Activity" from the expanded policy on timely disclosure.

Do you have that before you? A. Yes.

Q. Is that the provision which was in effect up to January 25, 1978 which is the date listed on a pertinent page of Plaintiffs' Dolan Exhibit 3? A. Yes, it is.

[57] MR. STERNMAN: How do you know that, Mr. Dolan? I mean, you know for a fact that there were no intervening changes between the date of this pamphlet and January '78? I just don't see how you could.

MR. ELKIND: Well, it is attached as an exhibit.

MR. STERNMAN: It may be the fact. I am not disputing it. I am just amazed that you sit here and swear under oath that you know that.

MR. ELKIND: You may be amazed.

MR. STERNMAN: This company manual is a looseleaf, is it not, and occasionally pages are changed and new pages are sent out to companies and inserted?

THE WITNESS: That's right.

MR. STERNMAN: And you know that there were no new pages between the date of this Exhibit 2 and January 25, 1978?

MR. ELKIND: I asked him whether that was a provision that was in effect.

MR. STERNMAN: No new pages on this particular provision. That was the first amendment. We can't see the date. Do you have the original [58] of this document with you, Ms. Simplicio?

MS. SIMPLICIO: I do, sure.

MR. STERNMAN: I don't think this is a significant point. I am just concerned in this deposition with what appears to be a number of leading questions directed to the witness and a willingness on the part of the witness to assume the accuracy of the suggestion contained in the question.

What is the date on that page in Exhibit 2, Mr. Dolan?

THE WITNESS: June 10, 1971.

Q. It is your testimony that you know for a fact as you sit here that in that nearly seven-year period there were no other—there were no changes made to that 1971 version of dealing with rumors of unusual market activity until the January 25, 1978 revision?

MR. STERNMAN: I just don't see how you could know that.

MR. ELKIND: Your editorialization is inappropriate. Let's move on.

MR. STERNMAN: I am trying to focus the witness on his obligations here, which is not to just take suggestions in your questions [59] and assume it is correct. I would like to see a record that is fair to both parties.

Q. Mr. Dolan, the expanded policy on timely disclosure was attached as an exhibit to the affidavit submitted by you to the Securities and Exchange Commission? A. Yes, it was.

Q. What was the date that that affidavit was prepared, approximately? A. Approximately August 1980.

MR. STERNMAN: Why don't you follow it up. You mean the SEC put the outdated version of the timely disclosure section onto your 1980 affidavit and you swore to it as accurate? I don't understand that.

MR. ELKIND: It is not an outdated version, Mr. Sternman. Read the provisions.

MR. STERNMAN: The January 25, 1978 version which Mr. Dolan has just testified to is the one in effect at that date which you have marked as Exhibit 3. It is very different from the one—

MR. ELKIND: It is not very different from the one. They are virtually verbatim. There is one page here that has a minor change, and [60] that is a matter of public record, Mr. Sternman.

MR. STERNMAN: Exhibit 2 that is attached to Mr. Dolan's affidavit, three, eight, nine, ten lines. The one that was in effect as of the date of the statements made in his affidavit and as of the date of the affidavit itself is three, six, nine, twelve, fifteen, eighteen, twenty-one lines.

I don't know how you can say there are minor changes. But I have asked the witness a simple question. Do you know why the SEC attached the wrong document to your affidavit?

Q. Let me direct you to the page that is numbered A-23 of Plaintiffs' Dolan Exhibit 3 which is the New York Stock Exchange company manual, and specifically to the paragraph dealing with rumors or unusual market activity.

Do you have that before you, sir? A. Yes.

MR. STERNMAN: This is from the company manual?

MR. ELKIND: Plaintiffs' Dolan Exhibit 3, which is the New York Stock Exchange company manual.

Q. You indicated that the effective date of that provision was January 25, 1978, is that correct? A. That's correct.

[61] Q. Let me ask you to read the first paragraph under the heading related to "Rumors or Unusual Market Activity," which begins, "The market action of a corporation's securities." I will ask the reporter to type that paragraph into the record while you are reading it, sir.

"The market action of a corporation's securities should be closely watched at a time when consideration is being given to significant corporate matters. If rumors or unusual market activity indicate that information on impending investments has leaked out, a frank and implicit announcement is clearly required. If rumors are, in fact, false or inaccurate, they should be appropriately denied or clarified. A statement to the effect that the company knows of no corporate investment to account for the unusual market activity can have a salutary effect. It is obvious that if such a public statement of this sort was contemplated, all levels of management should be checked prior to any public comment so as to avoid any embarrassment or potential criticism. If rumors are correct or there are investments, an immediate candid statement to the public as to the state of negotiations or the state of investment and corporate plans in the rumored area must be made directly and openly. Such statements, despite the business [62] inconvenience which may be occasioned and even though the matter may not as yet have been presented to the company's board of directors for consideration."

Have you had an opportunity to read that paragraph? A. Yes, I did.

Q. Does that represent the standards adopted by the New York Stock Exchange— A. Yes, it does.

Q. —applicable to public corporations listed on the Exchange? A. Yes, it does.

Q. Including Basic Incorporated? A. Yes.

Q. Were those standards in effect during the period January 25, 1978 through December 20, 1978? A. Yes, they were.

Q. Let me ask you to read the next paragraph, if you would, sir: "The Exchange recommends that its listed companies contact their liaison representative if they become aware of

rumors circulating about their company. Exchange Rule 435 provides that no member, member of an organization or allied member, shall circulate in any manner rumors of a sensational character [63] which might reasonably be expected to affect market conditions on the Exchange. Information provided concerning rumors will be promptly investigated."

Have you had an opportunity to read the paragraph, Mr. Dolan? A. Yes, I did.

Q. Does that set forth standards adopted by the New York Stock Exchange? A. Yes, it does.

Q. Applicable to public corporations listed on the Exchange? A. Yes, it does.

Q. Including Basic Incorporated? A. Yes, it does.

Q. Were those standards in effect during the period January 25, 1978 through December 20, 1978? A. Yes, they were.

MR. SIMPLICIO: Before you go on to anything new, I would like to take a break at this point.

(Recess taken.)

Q. Mr. Dolan, as a liaison official with the New York Stock Exchange during the period of 1976 through 1979 were you familiar with the standards of timely * * * *

[66] Q. When you are referring to what you would have done, does that, in fact, refer to what you believe that you did do at the time? A. That's correct. I believe that I did do it because it was the normal procedure to do it. I will qualify it by saying that I do not recall exactly if the specific Exchange policies were discussed.

Q. You mean as such? A. That's correct.

Q. But you did have discussions with representatives of the management of Basic Incorporated concerning the trading activity in the stock? A. That's correct.

MR. ELKIND: I would like the reporter to mark as Plaintiffs' Dolan Exhibit 4 a document entitled "Stock Watch Form" dated July 14, 1978.

(Document above referred to marked Plaintiffs' Dolan Exhibit 4 for identification, as of this date.)

Q. Could you identify Plaintiffs' Dolan Exhibit 4, please, Mr. Dolan? A. Yes, it is a stock watch form that the Exchange uses when there is unusual trading activity in one of its listed companies. Specifically, this relates to activity on July 14, 1978 as it occurred in shares of Basic [67] Incorporated.

Q. Does any portion of this document reflect your own handwriting? A. Yes, it does.

Q. What portions? A. In the particular line that starts with "Company contact, name and title" the writer is Ted Thomas, treasurer and secretary, and the time of the contact is also my writing, 3 o'clock. And, lastly, beneath the section "Representative's comments" that is my writing, "No corporate investments." And finally my signature at the bottom.

Q. Whose handwriting appears at the top of the exhibit? A. This would be the handwriting of our stock watch coordinator who would have been informed.

MR. STERNMAN: I am going to move to strike the answer at this point.

Q. Let me ask you to testify as to what facts you recall. You have used in the colloquial sense the words "would have," and if you could specify as to whether you have knowledge.

MR. STERNMAN: Can you describe it, Mr. Dolan?

[68] THE WITNESS: No, I don't know the particular individuals who filled that out at the time for certain. I have a pretty good idea.

Q. What is your belief as to whose handwriting appears at the top?

MR. STERNMAN: I am going to object to that question. It is another way of saying he has a pretty good guess. I object to the question as calling for the speculation of the witness.

Q. What is your belief as to whose handwriting appears at

the top of the document, Mr. Dolan? A. I know it is the stock watch coordinator who was monitoring it at the time. The individual who I believe filled that out who was the person who would normally be responsible for that particular function, his name is James Coufos.

MR. STERNMAN: I move to strike the answer as speculative.

Q. How do you know that the handwriting at the top is the handwriting of the person who was stock watch coordinator at the time? A. That would be the only person to give us this form to follow up on.

MR. STERNMAN: I am going to move to [69] strike the answer as speculative as to what would be the procedure.

Q. Is there a practice by which these forms were prepared at the New York Stock Exchange on or about the date which this bears? A. Yes, there is a definite practice.

Q. What is that practice? A. The practice would be for our market surveillance department who would have been informed of unusual trading activity by either a floor official down on the trade floor or by what we call a kick-out where a particular company's stock exceeds predetermined guidelines. That market surveillance representative would notify our stock watch coordinator in that particular department who would simply record this information and give it to the particular representative to contact the company.

Q. Is that the practice by which these forms were prepared?

MR. STERNMAN: Objection. I don't know what you mean by "these forms." That is one form we are talking about.

Q. Is that the practice by which forms, such as that, that has been marked as Plaintiffs' Dolan Exhibit 4, were [70] prepared? A. That's correct.

Q. Did you prepare the handwriting that appears at the bottom two-thirds of the page in the ordinary course of your duties at the New York Stock Exchange?

MR. STERNMAN: That entry into the lower left-hand portion which Mr. Dolan did not identify as his handwriting.

MR. ELKIND: Yes.

A. Yes, I do.

Q. Is that your signature on the signature line at the bottom of the page? A. Yes, it is.

Q. Prior to your filling out the entries in the bottom two-thirds of the page which you testified appear in your handwriting, did you receive this form with the handwriting that appears in the upper third of the page?

MR. STERNMAN: I am going to object to the continued leading of the witness. I think that he has clearly shown that he is willing to give you full and complete answers to all of your questions. I think you are getting on to documents that may have more significance now than the document that is the company manual, and I would ask you, Mr. [71] Elkind, to ask the witness what form he received the documents in and questions such as that, rather than suggesting to him the form in which he received it.

Q. In what form did you receive the document that has been marked as Plaintiffs' Dolan Exhibit 4? A. I received the form with the top third of the stock watch form already filled in. If you would like, I can be specific and go through each of the items that are checked, but there is nothing additional that I would have included for my own writing.

Q. You mean on the top third of the page? A. That's correct. The only item that would have occurred after I was finished with the form is that which is contained in the bottom left-hand corner.

Q. Did you, in fact, receive this document with the handwriting filled in at the top third of the page? A. Yes, I did.

Q. From whom did you receive the document? A. From the stock watch coordinator in our department.

Q. Did you receive this document from the stock watch coordinator in the ordinary course of your duties in the New York Stock Exchange? [72] A. That's right.

Q. Did you discuss the document with the stock watch coordinator? A. Yes.

MR. ELKIND: Off the record.

(Discussion off the record.)

MR. ELKIND: Read the last question, please.

(Record read.)

A. I don't recall having a specific conversation with the stock watch coordinator about the particular form. The form is designed to be self-explanatory and all pertinent information should be recorded on it to eliminate the need of further discussion.

Q. Did you receive forms similar to this from time to time regarding public corporations listed on the Exchange from the stock watch department? A. Absolutely.

Q. Was it part of your duties as a liaison with the New York Stock Exchange to receive and act upon such forms? A. Yes, it was.

Q. Was there a practice by which such forms were prepared by the stock watch department and delivered to [73] you? A. Yes, there's a practice.

Q. Is it also the practice for you to communicate with representatives of the stock watch department after receiving such forms? A. Yes, through the return of this form to that person.

Q. After you received this form, what would you do?

MR. STERNMAN: Talking about a form now rather than this particular form?

MR. ELKIND: Yes, general practice.

A. Well, I would read the top part of the form to see what we are talking about and what particular investment is at hand, and I would call my contact at the corporation.

Q. Then would you fill out the bottom portion of the form? A. I would relate to my contact. The reason for my call which would be specific as to the market activity in that company's stock and also speak generally about what is happening to the market as a whole like the the Dow Jones industrial average. I then would, as a general practice, go through the specific items that would [74] be indicated for possible reasons to account for this trading activity.

Q. With the individuals from the management of the corporation? A. That's correct.

Q. Would you then fill out the remainder of the form? A. That's correct.

Q. After receiving a response from the management of the corporation? A. The remainder of the form would be filled out as his response.

Q. What would you then do with the form after you filled out that portion? A. I would return it to our stock watch coordinator.

Q. Is that what you, in fact, did with this particular form which has been marked as Plaintiffs' Dolan Exhibit 4?

MR. STERNMAN: I am going to object. It is not clear if you are talking now about this last statement returning, or whether you are asking about a whole series of statements or the general practice. Would you clarify the question?

[75] MR. ELKIND: I am referring to the whole series of statements as to general practice.

MR. STERNMAN: I am going to object. I don't see how the witness can recall. I ask that you direct specific questions to him now concerning this form to see if he has a recollection.

Q. Did you, in fact, fill out this form and then return it to the stock watch department? A. I did.

Q. This is a form with which you are familiar? A. Yes, I am.

MR. STERNMAN: Mr. Elkind, we are shifting from practice to specific form to practice and I am not sure

from some of these questions where we are. Are you asking him whether this type of form that we have marked as Exhibit 4 is something he is familiar with or specifically Exhibit 4?

Q. Is Plaintiffs' Exhibit 4 a form with which you are familiar?

MR. STERNMAN: In its pure form or as filled in?

Q. Is Plaintiffs' Exhibit 4 a form with which you are familiar?

MR. STERNMAN: I object to the form of [76] the question.

A. Yes, I am.

Q. Plaintiffs' Exhibit 4, as filled in, is a form with which you are familiar? A. Yes, I am.

Q. Can you identify the initials in the bottom left-hand corner of the form? A. Yes, I can.

Q. Whose are those? A. That would be our representative from the market surveillance area who would have contacted our stock watch coordinator in our department.

MR. STERNMAN: You are testifying now as a matter of practice and not specifically as to what happened with this document because you used the phrase "would have" twice in your answer.

THE WITNESS: No, actually I am not speaking from a matter of practice because it doesn't always occur. In other words, there is not always some indication on the bottom left-hand side of the form. This particular individual is quite intelligent.

MR. STERNMAN: Do you know for a fact that he did the things that you described, [77] or is it your assumption based upon the fact that his initials appear that he followed this practice?

THE WITNESS: The latter.

Q. Do you know whose initials those are at the bottom left-

hand portion of the page, the name of the individual? A. I believe I know whose they are, yes.

Q. Who was that? A. His name is Richard Jacobi.

Q. Do you recognize his handwriting? A. That individual would not have put that on there.

Q. Who is it who in the ordinary practice at the New York Stock Exchange would have put his initials down there?

A. That would have been the stock watch coordinator who I believe would have been Jim Coufos.

Q. Is it your belief that it was Jim Coufos at the time? A. Yes.

Q. Upon what opinion is that belief based?

MR. STERNMAN: Totally irrelevant. What difference does it make who Mr. Coufos is or Mr. Jacobi was?

[78] A. At the time I believe that James Coufos was the stock watch coordinator who would have been responsible for all market activity.

Q. Is it your recollection that he was responsible for all market activity at the time? A. Yes, it was.

Q. Have you received handwritten stock watch forms from Mr. Coufos from time to time in the ordinary course of your duties at the New York Stock Exchange? A. I have.

Q. Is the handwriting on those or forms that you received similar to the handwriting that appears on Plaintiffs' Dolan Exhibit 4?

MR. STERNMAN: Which section?

Q. In the upper third of the page. A. I would be speculating. I mentioned I believe it is James Coufos. It might not have been.

MR. STERNMAN: If you are speculating, I would appreciate if you would stop at this point because the record should not contain your speculation.

Q. Do you have any reason to believe that the stock watch form did not come from the stock watch department? A. No.

[79] Q. After you returned to the stock watch department did anybody tell you that it was a form that didn't come from the stock watch department? A. No, they did not.

Q. Do you recognize the name Delaney that appears in the upper third of the page? A. I see the name Delaney, yes.

Q. Do you know who that refers to? A. Yes, I do.

Q. Who is that? A. That is a floor official who referred this form to the market surveillance area.

Q. Could you state his full name if you would, sir? A. His name is Frank Delaney. I don't know his middle initial. I know that he is a floor official on the trading floor. I do not know the firm's name.

Q. You said he referred this form? A. He referred this market activity in Basic to our market surveillance area who in turn contacted our stock watch coordinator who filled in this form.

Q. Does this stock watch form which has been marked as Plaintiffs' Dolan Exhibit 4 reflect events that occurred on July 14, 1978?

[80] MR. STERNMAN: I am going to object to you leading the witness. Why don't you ask him what the form reflects.

MR. ELKIND: That's a preliminary question, Mr. Sternman. That is perfectly appropriate.

MR. STERNMAN: Let's get the proper questions.

Q. What does the stock watch form that has been marked as Plaintiffs' Dolan 4 reflect? A. This form reflects market activity which we deem to be unusual in Basic, Incorporated on July 14, 1978 at 2:53 p.m.

Q. The time that's listed there in the stock watch form refers to what? A. The time that our stock watch coordinator actually filled in this form as he received the information from the market surveillance department.

Q. What was the market activity that is reflected in this form? A. In Basic Incorporated the stock at this time.

Q. On July 14, 1978? A. On July 14, The stock price was up 3 1/8 to 26 7/8 which was an annual high at that point on 18,200 shares. The general market activity as indicated by the Dow Jones [81] industrial average was up 10.14.

Q. Was the stock market activity in Basic Incorporated what you deemed to be unusual? A. I did not deem it to be unusual, The floor official, Frank Delaney, was instructed by an individual. I won't speculate on who that might be.

Q. Would you individually believe a price movement of 3 1/8 per share or a volume of 18,200 shares by 2:52 in the afternoon to be unusual in the stock of Basic Incorporated?

MR. STERNMAN: I object to that question. I don't think Mr. Dolan is here today to give us his response on what he would deem something to be or not. I think the deposition concerns facts of which Mr. Dolan is aware, and that question calls for his conclusion, opinion, speculation, and I object to it.

MR. ELKIND: I am asking him what his opinion was. Your objection is noted.

Q. Was it your opinion? I am not asking you who put the numbers on this form. I am asking you, sitting here today, is it your opinion that a price movement of 3 1/8 per share in Basic Incorporated or a volume of 18,200 shares by 2:52 in the afternoon on a single day [82] was unusual activity in Basic Incorporated's common stock?

MR. STERNMAN: I would ask counsel for the New York Stock Exchange whether this representative has been produced here today to render opinion on matters that are not reflected in the documents, that are not part of his factual recollection of the events. Is he here as a spokesman to give judgments that he has never formed before, or as a factual witness?

MS. SIMPLICIO: I think Mr. Dolan is qualified to answer that question.

MR. STERNMAN: Is it your intention today to let him render opinions on things that did not come into his mind during 1978?

As I understand the question, Mr. Elkind, it is not did he form an opinion at the time, but whether he will form an opinion today. Is that a fair understanding of your question?

MR. ELKIND: My question is clear on its face. Are you objecting? If you are objecting, simply state that you are objecting.

MR. STERNMAN: I don't think there is any qualification on the part of this witness to speak in any capacity if whether in his judgment four [83] years after the fact that particular trading movements were unusual or not. And if such opinions are rendered I would, of course, move to strike them. But also we'll have a very lengthy cross examination where I would take him through all the trading activity to find out what the basis of his opinion is.

MR. ELKIND: Don't make threats.

MR. STERNMAN: It is not threats. It's the way lawyers practice law.

MS. SIMPLICIO: Do you remember the question? Can you answer it?

THE WITNESS: Yes, I do.

A. I would not have been in a position to render an opinion, if this would constitute unusual trading activity. I was simply following instructions through the normal course of events in contacting the company. In my responsibilities with the company that I was a representative for I would have some input. This is an excess of 10 percent of the stock price of the company's stock and I would possibly concur in that stock watch coordinator's belief that this warrants a contact, but this still is not my responsibility to say I am going to contact him.

[84] MR. STERNMAN: I move to strike so much of the answer where Mr. Dolan speculated that he would have possibly concurred.

Q. Is this form which has been marked as Plaintiffs' Dolan Exhibit 4 a form that was sent to you when the stock watch

coordinator deemed the activity in Basic Incorporated securities to be unusual market activity?

MR. STERNMAN: I object to leading the witness. He has already testified, I think, in this subject area. Now you are restating it in your own words.

A. Yes, it was.

Q. Could you describe for me, if you would, the circumstances under which a form such as Plaintiffs' Dolan Exhibit 4 was sent to you by the stock watch department? A. Generally?

Q. Generally. A. The market surveillance department would be the recipient of, would make a determination of unusual trading activity if it exceeded the predetermined computerized guidelines. Another method in which they would be the recipient of information is if the floor official would contact them and tell them that on the basis of [85] discussions with the specialist who is that particular company's—actually, the person who trades the company's stock has brought it to their attention that there's unusual trading activity.

Q. Would those be the circumstances under which a stock watch form like this would be prepared? A. Those two circumstances, yes.

Q. Let me direct your attention to paragraph 5 of the affidavit which you submitted to the Securities and Exchange Commission. Let me ask you to read that paragraph and I ask the reporter to put it into the record.

MR. STERNMAN: May I ask before the witness reads it that you ask what he recalls about these events, or is it your intention just to ignore that and have him read what's recorded there?

MR. ELKIND: We've already gone over the events that are reflected in paragraph 5, and I am trying to clarify and go over the witness' recollection.

MR. STERNMAN: If that is so then you are merely asking questions that have already been answered. The affidavit is the affidavit and the witness is giving you his recollection.

[86] Q. Mr. Dolan, will you please read paragraph 5 of the affidavit, and I will ask the reporter to include that in the record.

MR. STERNMAN: I move to strike any reference to paragraph 5 of the affidavit. The witness' testimony concerning these events has already been elicited and this is a document that was prepared by the Securities and Exchange Commission, not by the witness.

Q. "On July 14, 1978, Basic common stock increased in price. By 2:52 p.m. of that day it was up 3 1/8 per share to 26 7/8, a new high price for Basic for 1978, on volume of 18,200 shares. As a result of the increase in price and volume, Mr. Frank A. Delaney, an NYSE floor official, requested that the stock watch department of the NYSE initiate an inquiry into the trading activity. The stock watch department checked the trading in Basic common stock, the trading in the stock of other companies in the same industry, and news releases, if any, by Basic during the past 90 days were reviewed. This information was placed on a stock watch form dated July 14, 1978 (Ex. B)."

Does paragraph 5 truthfully and accurately reflect the facts of the events of July 14, 1978?

[87] MR. STERNMAN: I object to the question. I think paragraph 5 on its face shows that there are events in which Mr. Dolan did not participate. All it reflects is the fact that the SEC gathered those facts together and somehow convinced Mr. Dolan.

A. The affidavit which I signed in 1980 was true and accurate, to the best of my recollection. At this time, I do not specifically recall if, for example, the stock watch was following the trading in Basic common stock. Perhaps almost two years ago I knew better and I can recall.

MR. STERNMAN: I would like to object to the last statement that Mr. Dolan made and I move to strike it. It is speculation as to what might have been two years ago.

Q. Does this affidavit including paragraph 5 reflect information given by you to the Securities and Exchange Commission? A. Yes, it does.

Q. In 1980? A. That's correct.

Q. Based upon your knowledge and information about the facts as they occurred at that time; is that correct? A. That's correct.

[88] Q. Was your recollection refreshed at that time?

MR. STERNMAN: Do you recall today the state of your recollection in 1980? I think that is Mr. Elkind's question.

Q. Was your recollection of the facts fresh in 1980 when you executed that affidavit?

MR. STERNMAN: I object to the form of that question. Also, it's leading. I don't know how anyone today is going to recall.

MR. ELKIND: Don't keep telling the witness what you don't know and what you don't believe and what you think impossible and what you think unlikely. State your objection.

MR. STERNMAN: Read the question.

MR. ELKIND: Read the question.

(Record read.)

A. My answer in 1980 would apply to the investments pertaining to Basic was to the best of my knowledge at that time.

Q. Thank you.

MR. ELKIND: Why don't we take a luncheon break now.

(Luncheon recess taken, 1:45 p.m.)

[89] * * * * Q. Let me place before you Plaintiffs' Dolan Exhibit 4 and Plaintiffs' Dolan Exhibit 1. Could you explain what the entries beside the caption "market activity" refer to on Plaintiffs' Dolan Exhibit 4? A. Yes. The stock watch coordinator has indicated what the market activity is in Basic

at that particular moment. Specifically, it says that the stock prices are up 3 1/8 points to 26 7/8. A parenthetical "new high" means that it's a new high for the year on 18,200 shares.

Q. Is that all as of 2:52 in the afternoon on July 14, 1978? A. Yes.

Q. Is that based upon your experience in receiving and reviewing stock watch forms such as this? A. That's right, it is.

Q. Let me direct your attention to Plaintiffs' Dolan Exhibit 1, paragraph 5. The first sentence of the affidavit states, "On July 14, 1978 Basic common stock [90] increased in price. By 2:52 p.m. of that day it was up 3 1/8 dollars per share to 26 7/8. A new high price for Basic in '78, on volume of 18,200 shares."

What was the basis of that statement in your affidavit? A. The basis is simply a recitation of what was put on the form by the stock watch coordinator indicating what the activity was for Basic up to 2:52 p.m. on July 14, 1978.

Q. Your affidavit goes on to state in paragraph 5, "As a result of the increase of price and volume, Mr. Frank A. Delaney, an NYSE floor official, requested that the stock watch department of the NYSE initiate an inquiry into the trading activity."

What was the basis of that statement? A. It is indicated on the form that the floor official had brought it to our attention that there was unusual trading activity.

Q. What portion of Exhibit 4 are you referring to? A. Below the typed "coordinator's comments" it is written in, "floor official requested." And, parenthetically, it says "Delaney." You will notice in the upper left-hand corner where a referral is checked, that means that somebody on the trading floor has brought it [91] to our attention.

Q. Is that too based upon your experience in reviewing the stock watch form? A. That's one method, yes.

Q. The next sentence of your affidavit states, and I quote, "The stock watch department checked the trading in Basic common stock, the trading in the stock of other companies in the same industry and news releases, if any, by Basic during the past 90 days were reviewed."

Then it goes on, and I quote, "This information was placed on a stock watch form dated July 14, 1978."

What was the source of that information in your affidavit? A. As I indicated earlier, I don't recall at this point that the stock watch department actually checked the trading in Basic, nor the other companies' in the industry, news releases, et cetera. But at that time if I indicated that was the case I would think that there was some knowledge to it.

MR. STERNMAN: I am going to object.

Q. You mean at the time of the affidavit? A. Yes.

MR. STERNMAN: If I have got a comment to make and you have asked me not to interrupt, [92] then don't jump in with another question when I am trying to move to strike his testimony.

I move to strike the last portion of the witness' testimony, as to what might have been or "this must have been the case at the time." We are here today just to get your recollection, Mr. Dolan, and not to get your speculation. My speculation is that the SEC put this thing in front of you and you signed it.

Q. Was paragraph 5 prepared based upon knowledge that you had at the time the affidavit was prepared? A. Yes, it was.

Q. You testified earlier that you received the stock watch form with the portion on the upper third of the document filled in; is that correct? A. That's correct.

Q. What did you do when you received the stock watch form? A. Initially, I read it and then I called Basic Incorporated.

Q. Who did you call at Basic Incorporated? A. My primary contact who was Ted Thomas.

Q. Did you reach Mr. Thomas? A. Yes, I did.

[119] * * * Q. Is that based upon your familiarity with documents of this form? A. Sure.

Q. Can you tell me what the entries on this document refer to? A. It refers to trading activity in Basic Incorporated up to 11:07 on the trading day of September 25, 1978 and subsequent action that was taken.

Q. Can you tell me what the entries under the heading beside box "Market Action Kickout" refer to? A. Yes.

Q. You see that the box for market action kickout is crossed? A. That's correct.

Q. What does that refer to? A. That means that particular trading activity in Basic Incorporated on this day exceeded our pre-determined acceptable guidelines for Basic Incorporated and therefore produced the kickout.

Q. What did you mean by "predetermined acceptable guidelines"? A. There are computerized acceptable guidelines that are established for all securities on the New York [120] Stock Exchange and once those numerical guidelines are exceeded it automatically registers on this computer printout.

Q. Do you know generally what those guidelines are? A. It varies from stock to stock.

Q. Does it relate to volume activity in the stock on a given day? A. It relates to both volume and price activity.

Q. What does the phrase "kickout" mean? A. That is what I was just referring to. It refers to that it actually comes out of this and we call it a kickout. It's a computerized recognition.

Q. Do you know what the handwriting under the heading "Description of Situation" signifies? A. Yes, I do.

Q. Will you please tell me. A. It is Richard Jacobi signifying that Basic Incorporated at 11:07 on September 25, 1978 was up 2 5/8 to \$33 per share on 32,500 shares trading volume.

Q. Under the heading "Action," could you tell me what that refers to?

MR. STERNMAN: Could you read it first, Mr. Dolan. I can't make out that handwriting.

[121] A. It appears to be, "Representative to contact-NCD."

Q. Do you know what that signifies? A. Yes, that is the representative contacted the corporate official at the company and following a hyphen, "NCD" which is an abbreviation for no corporate investment which signified the corporate official's response back to the representative.

Q. Is the stock watch on line alert report a document prepared in the ordinary course of business of the New York Stock Exchange? A. For those instances that there are unusual trading activities, yes.

Q. There came a point in time when you saw this particular stock watch on-line alert report?

MR. STERNMAN: Objection. It has already been asked and answered.

A. Yes, there did come a time that I saw the report.

Q. Was this a report that was prepared in the ordinary course of business on the New York Stock Exchange?

MR. STERNMAN: He has no knowledge of how or when it was prepared. He has even said it could be a forgery at one point.

[122] MR. ELKIND: That is utter nonsense. The witness has testified that he is familiar with the practices and documents prepared by the New York Stock Exchange.

MR. STERNMAN: That is as far as he can go.

MR. ELKIND: State your objection. Don't make speeches.

MR. STERNMAN: I don't know how the witness can know when this particular document was prepared.

MR. ELKIND: Just say you object. That is enough. Can I hear back my question, please.

(Record read.)

MR. ELKIND: I object. If you want to state the objection state it simply and concisely. You don't have to make a speech.

MR. STERNMAN: I think the witness' testimony at this point is that he was not there when the document was prepared. He is familiar with documents of this type but

not with this particular document until some point later in time when it was made available to him.

MR. ELKIND: Let's stop making these [123] objections.

MR. STERNMAN: Your pending question is whether the document was prepared in the ordinary course of business, and there is no way from the facts that he has testified to up to this point that he could know that about this particular document.

MR. ELKIND: That is your conclusion. He saw the document.

MR. STERNMAN: That's my objection.

MR. ELKIND: I am asking the witness' testimony. If you want to sit down I will take your testimony under oath.

MR. STERNMAN: You don't have the competence to do that.

MR. ELKIND: Maybe you don't have the competence to do that, and I would object to your unprofessional remarks. I thought that they would come to an end but I guess they haven't, Mr. Sternman.

MR. STERNMAN: Not when you conduct a deposition like that.

Q. Is the stock watch on-line alert report that has been marked as Plaintiffs' Dolan Exhibit 5 a document [124] that was prepared in the ordinary course of business at the New York Stock Exchange? A. Yes, it was.

Q. Is that based upon your familiarity with the document? A. Yes, and my familiarity with the procedure.

MR. STERNMAN: I move to strike the answer of the witness.

Q. Did you have occasion to discuss this document with anybody? A. At some point in time I did, yes.

Q. With whom? A. With Mr. Alfred Parisi, office of general counsel.

Q. Did you talk with him about the circumstances under which this document was prepared? A. Yes.

Q. I would like to direct your attention to Plaintiffs' Dolan Exhibit 7. Can you identify that document? A. Yes, I can.

Q. What is that? A. This is a six-week report of the trading activity in Basic Incorporated covering the period of [125] August 15 up to and including September 25, 1978. Trading activity being the open, high-low, closing price, change volume, et cetera.

Q. In the course of your duties as an official of the New York Stock Exchange have you become familiar with this form of document? A. Yes, I have.

Q. For what purpose was this particular report prepared, if you know? A. I don't know specifically.

Q. Are you familiar with the circumstances under which documents in this form are prepared in practice? A. Yes, I am.

Q. What are those circumstances? A. The circumstances would be, if there are unusual trading activities, to determine if the trading activity at that particular time exceeds the normal trading activity over the past six weeks both in price and trading volume.

Q. Are you familiar with other documents of this form? A. Yes.

Q. Let me direct your attention to the stock watch form that has been marked as Plaintiffs' Dolan [126] Exhibit 7. Can you identify that document? A. Yes, I can.

Q. Would you do so, please. A. It's a stock watch form indicating the trading activity in Basic Incorporated up to 11:25 a.m. on September 25, 1978.

Q. Can you identify the handwriting below the heading "Company Reply"? A. Only the handwriting that indicates the name of the company contact.

Q. That is Matthew Ludwig, senior vice-president of finance? A. That's correct.

Q. 11:30? A. That's right. The handwriting below the representative's comments and the signature.

Q. Is that your handwriting? A. Yes, it is.

Q. For all those entries? A. That's correct.

Q. Do you recognize the handwriting at the top of the page? A. I don't know the individual.

Q. Do you know what department the individual was [127] in? A. Yes, I do.

Q. What department? A. That would be the stock watch coordinator within the corporate services department.

Q. Did you place the handwriting that appears below "Company reply" on the document? Did you place that handwriting there in the ordinary course of your duties as an official of the New York Stock Exchange? A. Yes, that is my handwriting.

Q. In what form did you originally receive the stock watch form before you put the handwriting down? A. I received this form with the top one-third of the form filled out with the indicated information on it.

Q. From which department? A. From our stock watch coordinator in our corporate services department.

Q. Did you speak with anybody within the New York Stock Exchange about this document after you received it? A. No, I don't recall.

Q. Could you read the entries beside "Market Activity" going down on the page and indicate to me what your understanding is of those entries. [128] A. Reading to the right of "Market Activity" is "BAI," which is the company's stock symbol on the New York Stock Exchange.

Q. Is that Basic Incorporated? A. That's correct.

Next is an upward-pointing arrow followed by $2\frac{1}{2}$, meaning that BAI at that time was up $2\frac{1}{2}$ points or \$2.50 to 32 $\frac{7}{8}$.

Q. When you say "at that time" you are referring to 11:25? A. That's right. On a trading volume of 28,500 shares.

Q. At that point, that is 11:25, where was the Dow Jones Industrial Average, according to your documents? A. It was down. I can't read the last number but three dollars and 20-something cents.

Q. What did the remaining entries on this document indicate to you when you received it?

MR. STERNMAN: Why don't you ask him if he has a recollection of receiving the document and what the entries meant rather than leading him right now into

suggesting that he can recall today something that happened three and a half years ago.

Q. What did the remaining entries on the document [129] indicate to you when you received the document?

MR. STERNMAN: I object to the form of the question.

A. The information indicated on the document was other information that was pertinent to the trading activity in Basic up to 11:25 on September 25.

Q. What was that information? A. First, that it hit an annual high of 33 3/8 earlier on September 25. Next, a request that we contact the company. Next, the most recent earnings statement came out on August 7 and that was the second quarter earnings and it was 94 cents versus 1.10 for a comparable period.

Q. The year earlier. A. That's correct.

Q. What else did this document indicate to you? A. On the preceding Friday the stock price was up 2 1/8 on 31,900 and, last Friday, our stock watch coordinator asked that I request a new corporate investment statement from the company.

Q. After receiving this document did you, in fact, contact Basic Incorporated? A. Yes, I did.

Q. With whom did you speak? [130] A. I spoke with Matthew Ludwig, senior vice president of finance.

Q. At what time did you speak with him, if you can tell? A. That was at 11:30 a.m.

Q. What did you say to Mr. Ludwig and what did he say to you, to the best of your recollection? A. To the best of my recollection, I informed him of the trading activity up to that point on September 25. I indicated to him the reason for my call, which was to ask him if he knew of any investments to account for this activity.

Q. What did he say to you, to the best of your recollection? A. He told me that there were no corporate investments, that he had considered calling their specialist on the trading floor * * * *

[131] * * * * Q. What else did Mr. Ludwig tell you in the course of that conversation, as best you can recall? A. As best I recall, as I have indicated on the form on September 25, is that Mr. Ludwig has considered calling the specialist and that the company will consider and probably would make a no corporate investment statement. * * * *

[132] * * * * Q. Mr. Dolan, do you have a present recollection of what was discussed during the course of your conversation with Mr. Ludwig, apart from the document? A. Other than being familiar with this form I do not have a present recollection of exactly what I said to him and his verbatim response.

Q. Did you record Mr. Ludwig's response under the heading "Representative's Comments," at or about the time that you spoke with him? A. Yes, I did.

Q. That was the handwriting that you put there shortly after your conversation with him? A. At 11:30 on September 25, 1978.

Q. Does that handwriting reflect what Mr. Ludwig did in fact tell you at the time? A. It does.

Q. Accurately? A. Yes, it accurately says what Mr. Ludwig told me at that time.

Q. Do you have any reason to believe that anything recorded under the heading "Representative's Comments" is in any way inaccurate? A. I recorded what was told to me.

[133] Q. Virtually contemporaneously with the conversation? A. That's right.

Q. Did you go through each of the items listed in the middle of the page from "undisclosed merger and acquisition plans" down through "rumors or anything else which might be causing a reaction"? Did you go through these items with Mr. Ludwig in the course of your conversation with him on September 25, 1978? A. I don't recall at this time if I went through each of those items. It was my general practice to do so.

Q. It was still your practice at the time, at the time of this particular telephone call? A. Yes, it was.

Q. In September of 1978 was it your practice to go through each of these items in the same manner in which you testified you went through them on July 14, 1978? * * * *

A. It was my practice to cover those same items.

Q. Was it your practice to cover the same items in [134] the same way? * * * *

Q. That you say you covered them or that it was your practice to cover them in July 1978? * * * *

A. It was then and it is now. * * * *

* * * * Q. Was it your practice to cover the items listed in the middle of the page in the same way throughout 1978? A. Yes, it was.

Q. Was it your practice to cover those items in the manner that you described earlier? * * * *

A. Yes, it was.

Q. In the course of your telephone conversation with Mr. Ludwig on September 25, 1978 did he inform you that there had been rumors in the marketplace concerning a possible acquisition of Basic by another company?

[135] * * * * Q. During the course of the September 25, 1978 conversation with Mr. Ludwig did Mr. Ludwig inform you of any rumors in the marketplace concerning a possible merger or tender offer or acquisition of Basic Incorporated? A. No, he did not.

Q. Did he inform you about any undisclosed merger or acquisition plans? A. No, he did not. * * * *

[136] * * * * Q. Mr. Dolan, do you have a present recollection of [137] whether Mr. Ludwig advised you of any rumors concerning a possible merger or acquisition during the course of this September 25 conversation? A. I have a present recollection that Mr. Ludwig did not inform me.

Q. Do you have a present recollection of whether Mr. Ludwig informed you of any undisclosed merger or acquisition plans? A. I have a present recollection that he did not inform me.

Q. Do you have a present recollection that Mr. Ludwig informed you of any discussions between Basic and any other company interested in a possible merger, acquisition or tender

offer for Basic? A. I have a present recollection that he did not so inform me.

Q. Do you have a present recollection of whether Mr. Ludwig advised you of any earnings forecast prepared by the corporation? A. I have no present recollection. I have a present recollection that he did not so inform me.

Q. Do you have a present recollection of whether Mr. Ludwig informed you of any new investments relating to prior announcements? [138] A. I have a present recollection that he did not.

Q. Do you have a present recollection of whether Mr. Ludwig advised you of anything else which might be causing a market reaction? A. I have a present recollection that he did not.

Q. Had you been informed of any of those items would you in the ordinary course of your duties in filling out this report have recorded the information which you received on a copy of this form? A. Yes, I would have.

Q. Would it be your practice to record any information concerning any of the foregoing items on this form?

MR. STERNMAN: Objection. Same question. Asked and answered.

A. Yes, I would have.

MR. STERNMAN: I also object to both questions on the grounds that they are leading. If you want to know his practice ask him what his practice is. Do not tell him that you know what his practice is knowing that he is going to agree that that is his practice.

Q. Do you have a practice of recording information relating to one of the foregoing items on the form, if [139] you had received such information from an officer of the company pursuant to your inquiry?

MR. STERNMAN: Objection. I think the record is already tainted by your leading questions.

A. I absolutely do have that practice.

Q. What is that practice? A. To recall any response that the corporate official would tell me pertaining to any of those aforementioned reasons for possible and unusual trading activity.

Q. If a corporate official gives you a positive response to one of the items listed in the sheet would you have a practice of recording such a response?

MR. STERNMAN: I object to the hypothetical and speculative question.

A. Yes, I have a practice to so record.

Q. What is that practice?

MR. STERNMAN: I object. Asked and answered.

Q. Thank you. Let me show you a document which has been marked as Plaintiffs' Dolan Exhibit 8, and I ask if you can identify that document. A. Yes, I can.

[140] Q. Would you please identify it for the record. A. It's a news release by Basic Incorporated on September 26, 1978 as recorded by the Dow Jones tape.

Q. Is that a copy of the report on the release used across the Dow Jones news ticker? A. It appears to be. * * * *

* * * * A. The Stock Exchange has the Dow Jones tapes and any news announcement that comes over the tape, we would receive it.

[143] * * * * Q. Are you familiar with policies or practices as to what should be done at the New York Stock Exchange when you receive information pursuant to an inquiry such as that which you had on September 25, 1978 from management * * * *

[145] * * * * A. The practice that I refer to is if there was some positive response from the company, namely, that they are giving me some explanation of the unusual trading activity I would record it on the stock watch form. I would ask further details if they are not provided from the company officials and

I would notify the proper New [146] York Stock Exchange official of the company's response.

Q. Who was that person? A. It would be the stock watch coordinator usually.

Q. For what purpose would you notify that official? A. The New York Stock Exchange official?

Q. Right. A. So that first of all it would be an explanation for this stock watch form that was given to me in the first place and, secondly, depending upon the corporate official's response it might require further action.

MR. STERNMAN: I object to the speculation. The witness has testified he passes the information on to someone else. It seems to me the witness merely acts as an administrator. He gets the information and passes it along. You are asking for practices that are beyond the scope of his responsibilities.

Q. Would you, yourself, make a recommendation to the corporate official who would give you such information? A. The corporate official in consultation with myself would determine if further action is required by [147] the Stock Exchange with respect to that company's trading.

MR. STERNMAN: I move to strike that answer as making no sense.

Q. Have you had occasions in which you have contacted the management of a corporation and made the inquiries set forth in the stock watch form and in which you were told that there were discussions between that corporation and some other corporation concerning merger or acquisition?

MR. STERNMAN: I object to the question. We've now gone from specific questioning about Basic to a practice and now you are asking him about occasions where something may have come up.

Q. You may answer. A. I have had experiences where a company would respond positively to those particular investments.

Q. What did you do on those occasions?

MR. STERNMAN: Objection. Irrelevant.

A. I would so record the company's response on the form and I would have some conversation with that corporate official to elicit more details about what that positive response would be, and then I would notify the proper Exchange official of this company's response.

MR. STERNMAN: I move to strike the * * * *

[168] Q. What did Mr. Thomas say to you and what did you say to Mr. Thomas during that telephone call, as best you can recall? A. I can't recall specifically at this time exactly what transpired on the telephone call, but if I may refer to this exhibit, it may refresh my memory.

Q. Did you record the substance of that telephone conversation in Plaintiffs' Exhibit 11? A. Yes, I did.

Q. What portion of Plaintiffs' Exhibit 11 refers to the substance of that telephone call from Mr. Thomas?

A. In the section entitled, "Rep's comments," the second paragraph, the second sentence, is in essence my phone conversation with Mr. Thomas.

Q. Can you read that into the record. A. It says: "Company again knows of no reason for activity. Company had previously had a kickout, at which time a no corporate was given."

Q. During the telephone call from Mr. Thomas, did you ask him whether there were any undisclosed merger-acquisition plans? A. I don't recall at this time precisely what we discussed in that telephone call, but it would have [169] been my procedure to follow the enumerated items that might refer to unusual trading activity.

Q. You are referring to the items listed in the middle of the page on Plaintiffs' Exhibit 11 from undisclosed merger or acquisition plans to anything else which might be causing the reaction?

MR. STERNMAN: I am going to object to the form of the question. I think it is proper to ask him what he is referring to and not you tell him what he is referring to. Are you continuing to lead the question?

A. Yes.

Q. What items were you referring to as the—

A. They were the items immediately above the section entitled, "Rep's comments," beginning with, "Undisclosed merger or acquisition plans," through the item, "Anything else which might be causing the reaction."

Q. What would have been your practice to ask at or about the date of this telephone call—

MR. STERNMAN: Object to the form of the question.

Q. What was your practice to ask on the date of the telephone call from Mr. Thomas? Describe that practice for me, if you would please. [170] A. It would have been my practice to relate to my contact what was the trading activity up until that time. Further, to ask if any of the particular items that we just referred to, undisclosed merger or acquisition, et cetera, would be possible reasons to account for this unusual trading activity.

Q. Was it your practice to ask as of December 15, 1978 whether there were in fact undisclosed merger or acquisition plans?

MR. STERNMAN: Object to leading the witness. He told you what his practice was and now you are suggesting other things.

A. That would have been our practice, to follow that procedure.

Q. Was it your practice to ask whether there were new product discussions or contracts—

MS. SIMPLICIO: He already testified he would ask every one of those items that had been enumerated, including undisclosed merger and acquisition plans and anything else that might be causing the reaction. I think to

go through each and every one of these items is repetitious and we object to that.

Q. During the telephone conversation with [171] Mr. Thomas on December 15th, did you ask him why he had been unavailable earlier in the day? A. I can't recall if I did.

Q. Do you recall him telling you why he had been unavailable earlier in the day? A. No, I don't.

Q. Mr. Dolan, let me show you Plaintiff's Exhibit 1, which is the affidavit you submitted to the SEC, and let me direct your attention specifically to Paragraph 13. Do you have that before you, sir? A. Yes, I do.

Q. Paragraph 13 states, in pertinent part, and I quote: "At 2:25 p.m. of the same day, Mr. Thomas returned my telephone call. I explained the market activity in Basic's stock and asked him if there were any corporate developments to explain the unusual trading activity. He stated that the company knew of no reason for the market activity and that there were no corporate developments to explain such market activity. I went through the list of areas to be inquired of on the stock watch form, including 'undisclosed merger or acquisition plans.'

"It is my procedure to review this list and inquire of the corporate office about each of [172] these areas, including undisclosed merger or acquisition plans. In each case, Mr. Thomas responded there were no corporate developments. I noted my conversation with Mr. Thomas on the stop watch form (Exhibit F), signed and returned it."

Is that statement in your affidavit based on information provided by you to the Securities and Exchange Commission? A. Yes, it is.

Q. Is it accurate? A. To the best of my knowledge, it was.

Q. Did it accurately reflect your recollection of the discussion with Mr. Thomas on December 15th? A. Yes, it did.

Q. At the time you executed the affidavit. A. That is right.

Q. Mr. Dolan, let me direct your attention to Exhibit 11 once again please, if you would, sir. At the bottom of the page, the form says, and I quote:

"Unless the contact is the chief executive officer, he should ask that he be contacted regarding the inquiry. If he is out of town, attempt should be made to reach him since this may be indicative of developments. Alert the contact that unless we are [173] informed to the contrary, his/her response will be considered the company's and CEO's official response."

Did you have a practice during the period July 1978 through December 1978 of advising the contact at corporations of the substance of what was contained in that note?

MR. STERNMAN: Object to leading the witness.

MR. ELKIND: I will withdraw the question.

Q. Did you have a practice with respect to the substance of what was contained in that note on the stock watch form?

MR. STERNMAN: Same objection.

A. That was my practice.

Q. What was your practice? A. To follow that procedure and to ask the contact that his response should reflect company's official position.

Q. During the telephone conversation with Mr. Thomas on December 15th, did you ask him to contact the chief executive officer of Basic regarding the inquiry? A. I don't recall at this time if I asked him to [174] contact the chief executive officer.

Q. Did you have a practice on December 15, 1978?

MS. SIMPLICIO: It has been asked and answered.

Q. Do you recall specifically whether you asked Mr. Ludwig to contact the chief executive officer of the company during the stock watch inquiry on September 25, 1978? A. At this time, I don't remember asking Mr. Ludwig that question.

Q. Do you recall whether you asked Mr. Thomas to contact the chief executive officer of the company during the stock watch inquiry on July 14, 1978? A. I don't recall if I did that.

Q. What was your practice during the time of each of those telephone calls, if you would sir?

MS. SIMPLICIO: It has been asked and answered. I object to the repetition.

A. It was my practice then, as it is now, to follow the procedures outlined in this form, specifically to ask my company contact, if he's not the chief executive officer, that his response be that of an official position of the company.

**Excerpts from the deposition of Preston Insley
by Respondents**

[5] Q. Mr. Insley, would you state your address for the record? A. 20 Martin Lane, Downingtown, Pennsylvania.

Q. What is your present position? A. Vice-President, Group Controller, Industrial Products Group, Combustion Engineering.

Q. Where is the headquarters of that group? A. Stamford, Connecticut.

Q. And is there a facility near you in Pennsylvania? A. Yes.

Q. What facility is that? A. An office located at King of Prussia, Pennsylvania.

Q. Is the entire controller's function of the Industrial Products Group run from that office? A. The group department that reports to me is located there, yes. * * * *

[13] * * * Q. When is the first time that independent—what date do you recall as being a date when you became aware that there was a project in place to acquire Basic, Inc. by Combustion Engineering?

MR. STERNMAN: I object to the form of the question. It assumes facts not in evidence.

MR. CROSS: He referred to a project being conducted by other people earlier.

MR. STERNMAN: But it wasn't a project to acquire Basic.

That is your assumption.

BY MR. CROSS:

Q. When do you recall independent of this document having any connection with discussions or plans to acquire Basic Incorporated? A. Independent of this document?

Q. Yes. A. I don't recall exactly. I would say approximately March of 1978.

Q. You don't recall being involved in 1977? A. That is true. I do not recall being involved [14] in 1977.

Q. Do you recall the circumstances under which you became involved with the plans to acquire Basic, Inc.? A. The circumstances were that I was directed to do two things.

Go to Basic, Inc., and obtain some financial information from them, so that I could prepare some comparative financial statements.

And to also prepare some financial data for our CE refractory's operations, so that I could—they, the Basic management—could look at our operations with the purpose of either they could—they may want to purchase CE, or we may want to acquire them.

Q. Who gave you that instruction? A. James Kelly, my boss.

Q. Do you recall about when he gave you those instructions? A. Well, the visit—the first visit or the contact that I had was in March of 1978.

And I don't recall the exact day, but it was a week or so before that.

Q. How did he contact you to give you those instructions, by person or on the telephone? A. I really don't recall.

[15] Q. Did he give you anything in writing to guide you in your project? A. He gave me no written instructions.

Q. Did he give you anything in writing to guide you in your project, whether the instructions were in writing or not? A. I believe that he gave me a copy of a 10-K of Basic, Inc.

Q. What exactly did he say to you when he gave you the instructions, to the best of your recollection? A. How about going out to Basic, and getting together with their financial people, and trying to understand how they do their accounting,

so that we can exchange information in a more meaningful way.

Q. Did he tell you what his purpose was in obtaining this information or what Combustion's purpose was? A. At that point I believe all we said, let's see what they look like like a company.

Q. Did you discuss the fact that he was interested in acquiring Basic? A. I really didn't discuss it at that point.

I assumed that it could go either way. I assumed that—that might have been what he wanted to do. * * * *

[36] * * * * Q. Let me show you a document that was previously marked as Plaintiffs' Exhibit No. 112 (handing).

That was at Mr. Arnolt's deposition, the first nine pages of which are schedules in substantially the same form as Plaintiffs' Exhibit No. 121.

Do you recall delivering those nine pages without the handwriting, the first nine pages of Exhibit No. 112 to Basic personnel at the March 22nd meeting? A. Yes.

Q. Do you know whose handwriting is on Plaintiffs' Exhibit No. 112, the first nine pages? Do you recognize the handwriting? A. I am not a handwriting expert.

Q. It is not yours. A. No, it is not mine.

Q. It is not Mr. Kechjian's? A. No, either one of ours.

Q. Do you recall delivering anything else to Basic personnel at your meeting of March 22nd, other than these nine pages? A. No. I think that is all I gave them.

Q. Did you receive anything from Basic personnel at the March 22nd meeting? [37] A. Yes.

Q. Do you recall what you received? A. I received financial statements for Basic.

Q. Do you recall what those financial statements related to? Did it relate to all of Basic or to portions of Basic? A. I had statements for their Refractory Division, their Chemical Division, their Electronic Division, and their total consolidated results.

Q. What was your purpose in requesting that information from Basic at that meeting? A. To get a better understanding of their accounting and reporting procedures, and to assemble these comparative financial statements, that I had later prepared.

Q. Let me show you a document that was previously marked as Plaintiffs' Exhibit No. 44, and particularly I direct your attention to the first four pages of that document.

I ask you whether those are the schedules that you were referring to, that you referred from Basic at the March 22nd meeting (handing). A. (Perusing document.)

Q. I will note that I don't see among those four [38] pages a consolidated page. A. I think these are the four that I received—I received these four at that meeting.

Q. The column on Page 1 of Plaintiffs' Exhibit No. 44, that is headed Forecast, 1978.

Is that your handwriting? A. No.

Q. Do you know whose handwriting that is? A. No. This was on the schedules that we received from Basic.

Q. It was on it when you received it? A. Yes. Somebody at Basic.

Q. Did you receive anything else from Basic at that meeting, other than—let me withdraw that.

You testified earlier that you also received a consolidated financial statement or financial statement from Basic's consolidated.

Do you recall whether you got that at this meeting or at some subsequent time? A. The format of the consolidated may have been the 10-K's for the years that I didn't have a 10-K.

And I am not sure about how I got the consolidated, other than through the 10-K.

Q. Let me show you something that has been marked [39] as Plaintiffs' Exhibit No. 26, which is a twelve-page document, fourteen-page document, including the cover page and the table of contents, which contains twelve financial schedules. It is dated June 7, 1978. It is entitled, Preliminary CE Refractories.

I ask you whether you can identify that (handing)?
A. (Perusing document.)

Q. Can you identify that? A. Yes. Those documents are the documents prepared by me and Kechijian in preparation for this June 7th—

Q. In preparation for a meeting on June 7th? A. Yes.

Q. Can you tell me what was written underneath the part that has been blacked out underneath CE refractories?

There is a portion in the middle of Page 1 that appears to have been cross-scratched out with a pencil.

Do you recall what was under there? A. No, I don't.

Again, this appears to be a draft, and—I am not sure.
* * *

[60] Q. Do you recall whether that was shortly after the June 7th meeting? A. I believe it was. Several weeks after.

Q. In June or July? A. I don't recall. I don't recall.

Q. What does paragraph five say there? A. Assume pay—

MR. STERNMAN: Let him read it.

A. Assume pay 36,400,000-38,000,000 get roi.

Q. What does that entry refer to? A. (Perusing document.)

I really, you know, it is incomplete.

I guess it means—

MR. STERNMAN: When I hear you say you guess, it means you are speculating.

MR. CROSS: He wrote it.

MR. STERNMAN: Yes. Do you recall what that entry meant?

THE WITNESS: No. It is part of a long sentence of which I can't read part of.

I don't recall the meaning of it.

Q. Why don't you finish the sentence, what you can finish of the sentence?

What is the word get roi? [61] A. Assume 1978 and then something is illegible, and then DCF comma and then accounting roi.

Q. What does DCF mean? A. Normally I use that for discounted cash flow.

Q. All right. What is the rest of the entry? A. Return on sh equity. Shareholders equity. And then on shareholders equity plus 1st debt, long term debt.

Q. There is a word, I think, between the assume the 1978 and the return on shareholders equity lines that you read on the left-hand margin.

What is that? A. I don't know.

Q. You can't read it? A. No.

Q. It starts with a "g" or "y"? A. This word?

Q. Yes. A. That word is good will. Good will.

Q. Good will percentage sign? A. I think it is good will.

Q. Do you recall doing an analysis for Mr. Kelly of what you might have to pay for Basic in preparation for the June 7th meeting? [62] A. No, I didn't do any analysis.

Q. Do you recall doing an analysis of what Combustion's return on investment would be, if Combustion paid thirty-six to \$38 million for Basic? A. Well, I recall making some informal notes, such as this.

I don't recall preparing anything specifically for that meeting.

I don't know the time frame when I did that.

Q. Do you recall Mr. Kelly asking you to do some calculations? A. I don't recall him asking me to do it.

Q. You did it on your own? A. Probably I did.

Q. Where did you get the assumption, thirty-six to \$38 million? A. I don't recall.

Q. Is that based on some per share figure that you were given? A. No. I believe that I may have taken it, just as a rough measure, from the document that we looked at a long time ago here, strategic plan, which had a \$30 million objective there.

And used that as a starting point.

[63] Q. What caused you to make this analysis? A. I don't recall.

MR. STERNMAN: Let me ask you, what analysis are you referring to?

MR. CROSS: He said he did, whether it was at Mr. Kelly's instruction or his own initiative, did an analysis of what the return on investment might be, if thirty-six to \$38 million was paid.

He doesn't recall whether Kelly told him to do it or he did it on his own initiative.

[64] * * * * Q. My question is: what prompted you to do that? A. My curiosity, I wanted to see what it would do for the group that this would become part of, if we had made the acquisition rather than Basic, what it would look like.

Q. Did you assume that Mr. Kelly was going to make an offer at the June 7th meeting or was at least prepared to make an offer at the June 7th meeting? A. No, No.

Q. Were you doing this to be prepared to advise Mr. Kelly in the event that he asked about the feasibility of making an offer? A. I would say yes.

Q. Had you discussed with Mr. Kelly the feasibility of making an offer, if not at the June 7th meeting, some time in this time frame? A. I really didn't discuss it with him.

Other than going back to what he originally said, we may make an offer, or we may sell our Refractory Division.

At some point one of these options was likely [65] to occur. * * * * Q. Let me show you the next page in Plaintiffs' Exhibit No. 44, which contains some handwritten information, a good part of which I can't read at all. See whether you can have any better luck.

First of all, is that your handwriting? A. I think so.

Q. For clarity, when I say the next page, I will refer to the page that follows the page that is entitled Basic and has six numbered paragraphs down the left-hand margin.

Can you read the handwritten English note on the right-hand upper right-hand corner before we get to the numbers? A. I can read only these three bottom words.

Q. What are the three bottom words? A. Basic on preferred no.

Q. The numbers. can you tell me what those numbers represent? A. I really can't add anything to what I see there.

[66] I don't know.

I can't read it.

I can read a couple of them.

Q. It says, one of them says, CE shares. A. This says, CE shares—

Q. Five million, one hundred forty-eight Basic shares? A. No, that is not shares.

Q. What is it? Is it Basic? A. That is a bad copy. I don't know what it is. It could be Basic.

Q. Do you know what you were doing in this calculation? A. (Perusing document.)

Q. The last line says 4.49 per share CE earnings.

Do you know what the basis of that calculation is about? A. I don't recall what it was about.

I can see that it says, 4.49 and this says CE shares (indicating)?

I assume that that is the CE shares that we might have to pay the equivalent in CE shares that we might have to pay should we acquire Basic.

Q. Do you recall why you did that calculation in [67] preparation for the June 7th meeting? * * * *

[68] * * * * THE WITNESS: I would like to say that these statements here, whether I look at them now—

MR. STERNMAN: You are talking about the handwritten pages that follow the first four pages of Plaintiffs' Exhibit No. 44.

THE WITNESS: Yes.

BY MR. CROSS:

Q. All of the handwritten pages or some of them? A. I would like to say that one, two, three, four, five, six of them were definitely in preparation for this June 7th document, and our drafts, some of them are drafts.

Q. Plaintiffs' Exhibit No. 26? A. Yes.

Q. That is the June 7th document? A. Yes.

That the rest of the notes, the other handwritten notes, which is my handwriting, of which there are three—

Q. Just for clarity you are now referring to the document that has the word Basic at the top and five [69] numbered paragraphs down the left-hand margin, the pages that follows that, which is the page of calculations, that has 4.49 per CE share as part of it, and the page following that, that has the number, what is the number in the upper left-hand corner? A. It looks like eleven, five, nine.

Q. Those are the three pages that you are referring to? A. Yes.

Q. What about those three pages? A. I am not sure that these were prepared in the same—at the same time, while the other pages were prepared.

Q. All right. A. I am not sure that these were prepared, connected, at the same time that this first page was.

In other words, the three of them at different times than these, and these three may not have been prepared at the same time.

Q. All right. The page that has Basic at the top of it, you testified earlier that that page was prepared in connection with preparing Plaintiffs' Exhibit No. 26, the June 7, 1978 document. * * * *

[70] * * * * Q. You testified that Item No. 1 related to adding the names and it deals with the schedules. Isn't that right? A. That is correct.

Q. All right. And Item No. 2 related to making seven copies of it to give to them. Is that right? A. Yes.

Q. And Item No. 4 related to getting three copies of the pension and thrift plan to deliver to them at the June 7th meeting, didn't it?

Am I correct in my assumption that documents were prepared in connection with the June 7th meeting?

MR. STERNMAN: Three of the items were. I am very impressed with your recollection.

So your recollection is correct as to those three items.

Q. Items 1, 2 and 4 at least were prepared in connection with preparation of the June 7, 1978 document [71] which is Plaintiffs' Exhibit No. 26, and the meeting on June 7th. Is that right? A. That is true.

Q. Is it your testimony that items, the two items numbered three and the item number five were put on this sheet at some other time? A. All I am saying is that—

Q. We are focusing on that page. I understand the other two pages are different.

We are focusing on that, what was item number five, at the same time that items one through four were put on it. A. I don't know. I am not sure.

Q. Do you have any reason to believe that you prepared that, that document at two different time points? A. It would not be unusual for me to add notes to documents at different time periods.

Q. Would you explain to me what the significance of the curlicue cross marks through the items on that page is?

Do you see what I am referring to, the marks that strike through the writing?

Do those marks indicate that you have done the [72] item that is listed? A. That is my normal use of the mark, and I would assume so.

Q. All right. Does a similar mark on item number five indicate that you have done that item? The one that goes through the dash through the thirty-six to thirty-eight million? A. No. The whole thing looks very tentative. It looks as though it was not done.

Q. What is the significance of the slash mark through the dash between thirty-six million and thirty-eight million? A. None. There is no significance to that.

Q. So you don't recall when you did the return on investment analysis or when you wrote a note to yourself to do the return on investment analysis? A. That is true.

Q. Did you do it after the June 7th meeting? A. I don't recall. * * * *

[73] * * * * Q. Do you recall when you wrote the note to yourself to do that analysis? A. No.

Q. Did you talk to Mr. Kelly after the June 7th meeting about the Basic project?

MR. STERNMAN: You have asked this question.

MR. CROSS: That is right.

Q. Repeat for me one conversation that you said occurred within a few weeks after the June 7th meeting, where you asked, was any decision reached with respect to Basic and he responded, no.

Was there anything else to that conversation?

MR. JEAVONS: I will object. Because he didn't say for sure that it was a few weeks after the meeting.

Q. Was that the only conversation that you had with Mr. Kelly following the June 7th meeting? A. I believe so.

[74] Q. And he said no decision had been reached? A. True.

Q. Can you explain for us why after the June 7th meeting you would have written a note to yourself, to prepare a return on investment analysis on the assumption of thirty-six to thirty-eight million price for Basic? A. Since I don't know when I made the note, I can't give you any information other than that as to why I would have.

Q. All right. A. At that time.

Q. Turn to Page 2.

Do you have any information as to when you prepared the calculation on the page of handwritten notes that has on it, 4.49 per CE share?

Do you know when you prepared that calculation? A. No.

Q. Was it before June 7th? A. I do not recall.

Q. Was it after June 7th? A. I can't recollect.

Q. Was it on June 7th? A. I can say I didn't do it on June 7th.

[75] Q. Do you recall why you did that calculation? A. Specifically, no.

Q. Generally, why were you doing a calculation like that? A. As I said before, I just, for my own information, I was trying to estimate what the effect might be.

Q. You can't say whether you did that before or after June 7th? A. No. * * * *

[76] * * * * Q. Mr. Insley, let me ask you the question, do you have any knowledge as to why Plaintiffs' Exhibit No. 44 [77] appears in the form that it appears with the pages that are stapled together, stapled together in the manner that they are stapled together? A. (Perusing document.) * * * *

[80] * * * * Q. Do you know why Plaintiffs' Exhibit No. 44 is compiled the way it is compiled and appears in Combustion's files that way? A. No.

[81] Q. All right. A. I don't.

Q. Let us go back to the page that follows the handwritten sheet which you identified as being in your handwriting, which has in the upper left-hand corner what appears to be an 11.59 and then a series of numbers.

Can you tell me to what those calculations relate? A. (Perusing document.)

The question is, do I know—

Q. The question is, to what do those calculations relate? A. Relate?

Q. Let me ask it more directly, what are they? A. They relate to a determination of a value obtained when 1,387,383 shares are multiplied by twenty-two dollars and twenty-two and three-quarter dollars.

Q. That is the first calculation? A. Yes.

Q. All right. What do those numbers represent? The number of Basic shares outstanding at some point in time. A. I assume that is true.

I don't recall these numbers.

[82] Q. Do you recall where you got the information that you used in preparing this calculation? A. Probably—I shouldn't say probably.

The shares were obtained from the latest 10-K.

Q. Do you recall where the twenty-two and three-quarters came from? A. I do not.

Q. Did somebody give you that assumption? A. No.

Q. Is that the market price? A. It could have been.

Q. What is the number immediately under the result of that multiplication, 35,661? A. At that point it is just a number.

I don't know what the significance of that is.

Q. Down at the bottom, it says thirty-six million. A. Yes.

Q. How does that number relate to all the other calculations? A. It doesn't relate to them, per se.

It seems to be just a rounded off figure.

Q. What were you doing when you were preparing these calculations? What is the purpose for all these [83] calculations? A. I am not really sure. There is a lot of information on the page.

Q. Do you recall why you were doing this calculation? A. I don't recall specifically when I did them and exactly why I did it at the time.

Generally, as I said before, I wanted to determine what kind of investment or what the impact of various investment levels would be, so I had to come up with some kind of reasonable estimates.

Q. And this page represents part of that effort? A. That is right.

Q. Talking about an investment by Combustion in Basic? A. That is what this would have been.

Q. Do you recall when you did this? A. No, I don't.

Q. Before June 7th? A. I don't recall.

Q. It was after June 7th? A. I don't recall.

Q. Did anybody ask you to do this? A. I don't think I was asked to do this, but I don't recall whether I did it on my own or whether I was * * * *

[106] * * * * Q. Page 2 has dead burned dolomite at the top. A. Yes.

Q. Page 3 had electronic segment at the top. Is that right? A. Yes.

Q. Am I correct that Page 4 of your document is the document that we have marked as Plaintiffs' Exhibit 124, the document headed, Assumptions, which is the typed version of Mr. Kechjian's? A. That is correct.

Page 5 is more of my write-up from my visit, notes taken, written up from my visit.

Q. That is entitled, Chemicals Division? A. Yes.

Q. All right. A. And sixth, seventh, eighth, ninth, tenth, eleventh, twelfth, thirteenth, fourteenth, fifteenth, are another version of the same information that was prepared for the June 7th meeting, that I have previously identified. Down to here (indicating)? * * * *

[113] * * * * Q. Let me ask you the same question about Plaintiffs' Exhibit No. 45. A. (Perusing document.)

I do not recognize this handwriting.

Q. All right. Directing your attention to Plaintiffs' Exhibit No. 45 and equally to the text of Plaintiffs' Exhibit No. 15, and Plaintiffs' Exhibit No. 107, the first five pages of Exhibit 107.

What was the purpose in preparing in that form your notes and assumptions relating to Basic? A. I consider that to be part of doing a complete job on putting together financial statements, and to retain in a legible form that information for Mr. Kelly.

Q. All right. Did you deliver that document or a document substantially in that form without the handwriting to Mr. Kelly? A. I delivered a document substantially in this form to Mr. Kelly.

Q. Do you recall when? A. Prior to the June meeting.

Q. All right. A. I don't recall the exact date.

Q. Did you deliver it to him at or about the time [114] that you delivered the drafts of the financial statements that later became part of Plaintiffs' Exhibit No. 26 to Mr. Kelly?

A. Yes. It may not have been the same day. There were a series of delivery—

Q. He had this document with him when he went to Cleveland on June 7th; isn't that right?

MR. STERNMAN: If you know.

Q. Do you know? A. I don't know that he had this document, no, I don't know that he did or didn't.

Q. You recall that he mentioned that he used the drafts of the financial statements of June 7th, do you recall him discussing, showing these assumptions and information to Basic personnel at the June 7th meeting? A. No, I didn't—

Q. You didn't discuss it— A. Exactly whether he did or didn't give him that information.

Q. When did you discuss with Mr. Kelly the fact that he had used the drafts of the financial statements that later went into Plaintiffs' Exhibit No. 26 at the June 7th meeting? When did you discuss that with him? * * * *

[141] * * * * A. I have nothing to add as to the discussions with Mr. Kelly about that meeting.

Q. Let me show you Plaintiffs' Exhibit No. 128.

I ask you whether you can identify it. A. (Perusing document.)

Yes. I have seen this.

Q. Where did you get it? Was it in your files? A. I think this was given to me, it was in my files.

Q. Who gave it to you? A. Mr. Ludwig at the March meeting.

Q. Do you know what the source of that information is? A. The source of it?

Q. Yes.

MR. STERNMAN: Don't refer to what appears on the document itself.

Mr. Cross can figure that out.

Other than what appears on the face of the document, do you have any information about the source of it? A. No. * * * *

**Excerpts from the Deposition of James B. Kelly
by Respondents**

[30] * * * * Q. When did you first become interested in expanding your refractories operation beyond the alumina refractories? I'm sorry, you said alumina? A. Alumina.

Q. (Continuing) refractories area. A. In the, somewhere around 1965, I would believe would be the time.

Q. That is when you first considered it? A. Right.

Q. Did you take any action with respect to that consideration at that time? [31] A. We had some meetings with Basic Incorporated at that time.

Q. Who initiated those meetings? A. We did.

Q. Was that the first time that you had met with Basic Inc. in connection with an interest of Combustion Engineering in entering the magnesia refractories area? A. I believe so. * * * *

[32] * * * * Q. What was the substance of those conversations? A. We were trying to see if Basic would be interested in becoming a part of Combustion.

Q. And were these all in a relatively confirmed time period of 1965? A. I'm not sure if it was 1965, but it's in that time range, and I would say within six months to a year these meetings took place.

Q. Would it be fair to say an acquisition was not agreed to? A. That's correct. * * * *

[40] * * * * Q. Who initiated the conversations in September—in 1976? A. I did.

Q. Who did you call? A. Max Muller.

Q. Is it fair to say you initiated the conversations by telephone call? A. Yes.

Q. Did you speak with anyone else prior to the first meeting besides Mr. Muller? A. Not that I recall.

Q. Do you recall who attended the first meeting in 1976? A. No.

Q. Was there a first meeting in 1976? My primary questions related to conversations. Was there a meeting in 1976? A. I believe so, yes.

Q. You don't recall who attended it? A. No.

Q. What was the substance of the conversation at that meeting? [41] A. To—my purpose was to renew contacts with Basic.

Q. With a view toward a possible acquisition? A. That was my hope, yes.

Q. What had prompted your desire to renew contacts with Basic? A. As far as I was concerned, in the business of the Industrial Products Group, I had a continuing interest during this time period of entering the basic refractory business, meaning little basic, meaning basic as a category of refractories.

Q. As I understand basic in this context, it is basic as contrasted to acidic; is that correct? A. That's correct.

Q. It is OH groups? A. Right. I always had this interest and I had three problems.

One was, the biggest one was there was a, during this time period, of antitrust question, and Combustion is a very conservative company. And if there is any doubt at all, we will not pursue an acquisition, if there was any possibility of antitrust problem.

The second was to convince Combustion's management that we ought to do it, and the third was to [42] convince Basic, if possible.

And about this time a development occurred which tended to do away with the antitrust question.

Q. What development was that? A. It was proceeding by the Federal Trade Commission against Kaiser Refractories in connection with an acquisition they made of Lavino Refractories.

And in that proceeding the Federal Trade Commission took the position that the basic refractories market was a separate market.

Q. Just to clarify that, now you are talking about, this is in the 1976 time frame? A. Yes, right in this area.

Q. Just to clarify, am I correct from—am I deducing correctly from your testimony that the alumina refractories area is an acidic— A. Correct.

Q. —refractories area whereas magnesia is basic? A. Right.

Q. And the Federal Trade Commission according to your understanding took the position that there were distinct submarkets as between acidic and basic— A. Right, the basic market was a market by itself, and they were attacking the acquisition of Lavino which was [43] a basic manufacturer by Kaiser who was also a basic manufacturer.

Q. Do you recall when in 1976 you first determined to actively pursue entering the basic refractories area? A. It was in the fall.

(Whereupon, the witness and his counsel confer off the record.)

Q. During this period in 1976 did you consider the possibility—let me withdraw that. Let's fix the time frame a little bit better, first.

MR. CROSS: I will have the reporter mark as Plaintiffs' Exhibit 4 a two-page partial document entitled CE Refractories Strategic Plan, 1977-1983, dated August 23, 1976. It has got the production number CE-2-1 on the front cover.

(Whereupon, a two-page document entitled CE Refractories, Strategic Plan 1977-1983, dated August 23, 1976, No. CE-2-1 was marked Plaintiffs' Exhibit 4 for identification, as of this date.)

BY MR. CROSS:

Q. Mr. Kelly, can you identify what that document is or what the pieces of that document are (handing)? [44] A. (Perusing document.) Yes, that looks like an excerpt from a strategic plan of CE Refractories.

Q. Does the date August 23, 1976 help refresh your recollection as to when you began developing plans to enter the, or developing new plans to enter the basic refractories area? A. From this time period.

Q. Typically how far in advance of a publication of a strategic plan such as this would consideration and drafting begin of such a document? A. It would—I think the time schedule is somewhere in the early summer.

Q. At the time that the consideration of entering into basic refractories was developing as part of the strategic plan for Combustion Engineering's refractories operation, had you discussed the matter with Basic? A. Say that again?

Q. Let me rephrase that.

Prior to this date and formally making the entry into the basic refractories area part of the strategic plan of Combustion Engineering had you discussed the topic with Basic in 1976? * * * *

[51] * * * * Q. Do you have recollection of a meeting prior to August 23, 1976? A. No.

Q. Mr. Kelly, prior to the period September-October 1976 did anyone to your knowledge from Combustion Engineering have any contact with Basic Incorporated on the topic of a possibility of an acquisition?

MR. STERNMAN: Other than the mid-sixties?

Q. Other than the people in the mid-sixties who you identified.

MR. CROSS: Although I think he identified only himself.

Q. Are you aware that anyone else from Combustion Engineering was talking to Basic? [52] A. No.

MR. CROSS: I will have the reporter mark as Plaintiffs' Exhibit 5 a document, appears to be a letter from Mr. Kelly to Mr. Muller dated October 18, 1976, produced as B-3-1 by Basic Incorporated.

(Whereupon, a letter to Mr. Muller, from Mr. Kelly, dated October 18, 1976, No. B-3-1 was marked Plaintiffs' Exhibit 5 for identification, as of this date.)

BY MR. CROSS:

Q. Mr. Kelly, preliminarily, is that your signature (handing)? A. (Perusing document.) Yes.

Q. Did you send that letter? A. Yes.

Q. Do you recall receiving the response that is indicated in handwriting in the upper right-hand corner? A. Yes.

Q. The document indicates that there was a telephone conversation, quote, the other day, close quote, which I take it is prior to October 18, 1976; is that correct? A. Yes.

[53] Q. Do you recall that telephone conversation? A. No.

Q. Do you recall whether prior to this letter and that telephone conversation there was a face-to-face meeting with representatives of Basic? A. I don't recall.

Q. Do you recall how your initial contact in 1976 with Basic was achieved? A. I believe I called up Max Muller.

Q. Do you recall what the subject matter of that conversation was? A. Not specifically, no, I don't.

Q. Other than renewing contact? A. No.

Q. Did you discuss the breakdown of ceramic sales? A. In the initial contact?

Q. Yes. A. I don't believe so.

Q. So is it fair to say that the initial contact was prior to the telephone conversation referred to in this letter? * * * *

[54] * * * * Q. And you don't recall whether there was a face-to-face meeting prior to this conversation? A. No, I don't.

Q. What was the significance of breakdown of Basic's ceramic sales for 1975? A. That was a part of an antitrust review going on by our counsel. * * * *

[55] * * * * Q. Had you had discussions with Mr. Muller during which you revealed that Combustion Engineering was having an antitrust review done in connection with your discussions with Mr. Muller and Basic regarding the possibility of an acquisition by Combustion Engineering? A. I don't recall.

Q. Do you recall what you told him in making the [56] request that he break out his ceramic sales for 1975? A. No.

Q. You just, as far as you can recall, you just asked for the data and he gave it to you? A. I do not recall the conversation.

Q. Do you recall whether in that conversation other topics were discussed? A. No.

Q. Do you recall the conversation at all? A. No.

Q. But you recall what the topic was, you recall why the topic of ceramic sales was relevant? A. I recall why I wrote this letter, yes.

Q. Can you read the parenthetical at the upper right-hand corner? A. Here or here (indicating)?

Q. The handwritten note from somebody called Max, who I take it is Max Muller. A. The whole thing?

Q. I can read the Dear Jim, here are the 1975 figures, please keep—looks like confidential, it has been cut off, but can you read the parenthetical? A. Only you and counsel, I think that must mean; I must say, I don't know what that last word is.

[57] MR. CROSS: Can you help us, Mr. Sternman?

MR. STERNMAN: We will look to see if we have a better copy of that. It does appear to look like C-o-u-n, but if you choose to examine Mr. Muller, you can ask him. I never noticed before that was cut off, I will make a note to get you a better copy if we have.

Q. Do you recall how long before this letter your Combustion Engineering's antitrust review had commenced? A. No.
* * * *

[59] * * * * Q. Mr. Kelly, do you recall who in Combustion Engineering directed counsel to perform an antitrust review? A. I requested it.

Q. Did you request it after consultation with anyone else in Combustion Engineering? A. No, I don't believe so.

Q. It is your testimony you do not recall when you requested it? A. I don't recall, no.

Q. But it was certainly prior to October 18, 1976? A. It was around that time. I don't know if it was before or after.

Q. Had you requested that antitrust review before or after your initial contact with Basic Incorporated in 1976? A. I don't recall when my initial contact was so I really can't say.

Q. What I am asking is, did you request the antitrust review before even contacting Basic or was it after you made the initial contact that you asked for the antitrust review. A. I can't recall.

MR. CROSS: Let me have the reporter mark a document produced as CE-3-1, which is the same letter marked as Plaintiffs' Exhibit 5. I * * * *

[64] A. It was submitted to the Vice President of Organization and Planning, and he makes some sort of distribution to the corporate staff.

And the corporate staff develops responses to the initiatives, and the responses eventually come back to the group and usually under Mr. Santry's signature. He is the President of the company.

Q. In this period of time, 1976, how does that planning process relate to the operation of the Executive Committee of Combustion Engineering? A. Not related.

Q. So it is possible that the planning process would give less than full approval to an initiative but the Executive Committee could, notwithstanding that, authorize an initiative? A. Yes.

Q. Is that what happened in this case? A. Yes.

Q. Do you recall making a presentation to the Executive Committee of Combustion Engineering in the fall of 1976? A. Yes.

Q. What was the reason that you made such a presentation? A. To see whether the Executive Committee approve or [65] make an approach to Basic.

Q. Did you initiate that presentation? A. Yes.

Q. Was that following the less than full approval received from Corporate in respect of the Industrial Products Group strategic plan, which is Plaintiffs' Exhibit 7? A. I don't believe so.

Q. Do you recall whether at the time you put that to the Executive Committee you had received a response to the strategic plan? A. I don't believe we had.

Q. Would you explain why you would—forgive my characterization—but why you would be simultaneously petitioning two different organizations for the same approval? A. We were following the planning procedures laid down by the company.

Q. Is it part of those planning procedures to seek approval of initiatives through the planning process and simultaneously seek approval through the Executive Committee? A. No.

Q. What is the—if you had received full approval for the initiative set forth in Plaintiffs' Exhibit 7, would it have been necessary to seek approval of the Executive Committee? A. Yes. In Combustion, we cannot make an acquisition [66] without the approval of the Executive Committee of the Board of Directors.

Q. I understand you cannot make an acquisition, but the question is, could you even seek to make an acquisition. A. In this particular case we thought it important that the Executive Committee not be uncomfortable with the possibility that we might try to acquire Basic Inc., and that was the purpose of the presentation. * * * *

[67] A. It's the minutes of an Executive Committee meeting of the Board of Directors on November 18, 1976.

Q. I notice that it is not a signed copy of the minutes.

Does it fairly and accurately reflect the discussion that you recall of that meeting? A. Yes.

Q. Did you make the presentation personally? A. Yes.

Q. Did you make any kind of written presentation at that time? A. No.

Q. Did you have any aide-memoire from which you spoke? A. No.

Q. Do you know what I mean by the phrase aide-memoire? A. Notes?

MR. STERNMAN: I don't.

Q. Notes or outline.

Did you distribute anything at the meeting? A. No.

Q. Did you make any kind of visual presentation, slides, flip charts? A. I don't recall.

Q. Are those meetings recorded in any fashion? A. You mean like this or (indicating)—

[68] Q. Yes. A. No.

Q. Tape recorded? A. No.

Q. Stenographically? A. No.

Q. The next to last paragraph on Page 4 of the document indicates that it was the sense of the meeting that the management of the company should continue to proceed with its investigations, preparations and as appropriate, negotiations with respect to the acquisition of Basic; is that correct? A. Possible acquisition of Basic.

Q. Right. A. Right.

Q. That was your understanding of the sense of the meeting? A. Yes.

Q. In Combustion Engineering is there any formal resolution process at the Executive Committee meetings? * * * *

[69] * * * Q. Mr. Kelly, do you know whether or not the Executive Committee of Combustion Engineering proceeds by formal resolution or simply by, as this document indicates, the sense of the meeting?

MR. STERNMAN: As a general practice?

MR. CROSS: As a general practice.

A. If there is action to be taken, I would believe there is specific resolution.

Q. Such as action in 1978 when the acquisition of Basic was actually approved, is that right? A. I don't—

Q. There was a resolution— A. There was a resolution? I don't recall.

Q. I think there was, but we will get to that. * * * *

[82] * * * * BY MR. CROSS:

Q. What is the only thing that you recall them saying through all these meetings? A. Their basic theme was that they wanted to remain independent and they weren't interested in being acquired. And that continued throughout this whole time.

Q. What is this whole time? A. I would say until the final meeting at which an offer was made to them and they accepted it in 1978. * * * *

[120] * * * * Q. 2 is not? A. No, no, I have a stock quoter in my office who knows probably better than Mr. Muller does what his stock is doing.

Number 3 is what Muller told me. The first line of No. 4 is what Muller told me.

The rest of 4 is not, does not deal with what Muller told me. And No. 5 is what Muller told me, to the best of my recollection.

MR. STERNMAN: What about the entry on Page 2; is that part of your discussion with Mr. Muller—

THE WITNESS: No, it's a report to Mr. Santry of where I will be if he wants to get a hold of me.

BY MR. CROSS:

Q. Turning your attention to the page that is entitled Businesses, whose businesses are you describing on that page? A. Those are Basic's businesses.

Q. On the next page it states, assume all preferred converts and all options exercised by year end 1978.

Are you talking about Basic's securities there? A. Yes.

Q. What is the significance of that assumption in your presentation to First Boston? [121] A. How many shares could ultimately be outstanding that would have to be dealt with.

Q. And the share figure set forth below, that is your assumption as to how many shares would be outstanding by year end 1978? A. If these things happened.

Q. If those assumptions above occurred, that is how many could be outstanding; is that correct? A. That's right.

Q. The net worth figure that is set forth on this page, where did you get that? A. My best estimate of what it would be at the end of the year.

Q. Based on what sort of calculation is that net worth figure arrived at? A. Earnings for the first six months and what they might earn in the next six months.

Q. What information did you have available to you at that time with respect to earnings for the second six months? A. I don't recall.

Q. You are dealing strictly in public information or have you been receiving information from Basic? * * * *

[122] * * * * Q. Were you relying in preparing this data strictly on public information or had you received information from Basic? A. I don't recall whether I had received any information that was non-public from Basic at this time.

Q. And is the same thing true of the debt figure? A. Yes.

Q. I take it the book value figure, the book value [123] figure, is that based on some piece of information that was given to you or is that simply your calculation? A. Divide net worth by shares outstanding.

Q. The next page describes, the first portion of the next page describes Basic management goals. What are you trying to describe to First Boston there? A. What I perceived as their goals.

Q. What do you mean by join CE? A. Become a part of CE.

Q. Are you talking about the management team would desire to continue as management of Basic when management became part of CE? A. No.

Q. What do you mean by that? A. What did I mean at the time?

Q. Yes. A. I thought they thought Basic would be a good addition to Combustion and they would like to see Basic go there.

Q. Who is they? A. That's my perception of what the people at Basic, that I was talking to, felt.

Q. All right, so it is not a question of what Basic's management itself wanted to do as people— A. Right.

[124] Q. —but rather what their perception of the desirability of a merger or acquisition of CE would be; is that correct? A. Say it again.

Q. I am trying to draw the distinction which I think you just drew in Number 1, and Basic's management goals, does not refer to the personal aspirations of Mr. Muller and Mr. Ludwig for continued employment. A. No, because they were going to retire.

Q. So what Number 1 reflects is your perception of their desire for Basic's future, that it was—

MR. STERNMAN: Don't characterize it.

MR. CROSS: I am trying to summarize what I think he said.

MR. STERNMAN: He said what he said. That is in the record and what happens once you start to summarize it—I am going to ask that the answer be read back.

You are trying to draw a distinction between individual management and corporate desire. I think if you stop the question at the point where it was, I won't have any objection. * * * *

[125] * * * * Q. Paragraph 2 of Page 6 of this document. Plaintiffs' Exhibit 17, says, get their price.

What did you mean by that or what were you conveying to First Boston by that? A. That they wanted to get a fair price for their company.

Q. Did that proposition which I gather is a general proposition in merger and acquisition situations, have any specific parameters on it as of the time that you prepared this slide presentation? A. No.

Q. And have you discussed what a fair price might be? A. At this time?

[126] Q. Yes. A. At one meeting, I did suggest I would be willing to work or recommend to Mr. Santry a certain number, a certain price per share. And I think their response was that wouldn't be high enough.

Q. Let me direct your attention to Page 1 of Plaintiffs' Exhibit 17, where it indicates First Boston personnel stated that a price of \$32—that a price of \$32, the ROI—I take it that is return on investment? A. Right.

Q. (Continuing) Developed were among the best that they had seen in all companies reviewed.

Is \$32 a share a number that you had ever discussed with Basic? A. No, I don't believe so.

Q. As of the writing of this document. A. I don't believe I ever discussed that number with them.

Q. Do you recall whether this discussion that you did have with Basic was prior to or subsequent to this document? A. I don't recall, but you do have minutes of the meeting.

Q. I am sorry, minutes of which meeting?

MR. STERNMAN: You said minutes.

[127] A. You have my memo which describes what went on at that meeting at which I suggested \$28 was a price that I could recommend to Mr. Santry. If we look at this, we can determine whether this was before or after that.

Q. That was what you were talking about? A. Yes.

Q. It is a question of that and determining the date? A. Yes.

(Whereupon, the witness and his counsel confer off the record.)

Q. Paragraph 3 indicates that one of Basic's management goals was to avoid exposure. To what does that refer in the context of this presentation to First Boston? A. I believe it was their desire to proceed in a way in which there would be no legal liability to their directors.

Q. What in specific was their concern—withdraw that.

MR. CROSS: Off the record.

(Discussion off the record.)

BY MR. CROSS:

Q. What specifically was Basic's management concern over legal exposure for their directors? * * * *

[128] * * * * A. I don't believe they ever specifically told me what their concerns were, but they were always approaching in a deliberate and steady way, as far as I was concerned, and seemed to be consulting with their outside counsel as we went along. So I got the impression that they were very cautious in this area.

BY MR. CROSS:

Q. When you made this presentation to First Boston, I assume that you didn't simply flash the slide on the screen and then go on to the next slide; that the purpose of presenting the slide show was to discuss the items presented in the slides in some organized, rational fashion; is that correct? [129]

A. Some things, yes.

Q. Did you discuss this item with First Boston? A. I don't recall.

Q. Why did you deem it appropriate or important to place this item before an investment banker as one of the goals to be accomplished?

MR. STERNMAN: As a Basic Management goal as perceived by Mr. Kelly?

A. That's correct, that's what I perceived. And I thought I was giving him all the information I could about the attitude of the Basic people.

Q. But you did not have anything specific in mind?

A. No.

Q. To what were you referring when you have here tax free exchange? A. Either they told me or I got the impression that they wanted the exchange to be a tax free type transaction rather than a taxable transaction.

Q. Without getting into the intricacies of tax law, does that mean some form of stock for stock deal? A. Yes, rather than—

Q. A cash transaction would not be tax free? A. Correct.

Q. Below that you have got CE management goals.

[130] A. Right.

Q. No good will. To what does that refer?

(Discussion off the record.)

A. That refers to an item that we would have if we made a cash purchase of Basic for more than book value.

Q. Item 2, I take it, is self-explanatory? A. Right.

Q. Item 3, what do you mean by pooling, if possible? A. That would be the accounting treatment of a merger which was stock for stock or our stock for assets which would allow us to avoid good will.

Q. On the next page you have alternatives. Are these all—I gather from the type of alternatives expressed, that these were alternative forms of a transaction for Basic; is that correct? A. That's right.

Q. Are these your proposals or are these proposals arrived at following consultation with First Boston or members of the financial staff? * * * *

[131] * * * * Q. This page sets forth alternative forms of the transaction, right? A. That's correct.

Q. Whose alternatives are they? A. Mine.

Q. Developed entirely by yourself? A. Yes. * * * *

[186] A. That sounds familiar. * * * *

Q. Was the subject which was discussed at the November 18, 1976 Executive Committee meeting at which you made a presentation about Basic raised or discussed in the Executive Committee subsequent to that date and prior to the date on which the Executive Committee authorized the acquisition of Basic some time in December [187] of 1978? A. Yes, there was another meeting.

Q. Do you recall when that meeting was? A. I believe it was in 1978.

Q. Just one other meeting? A. Yes.

Q. Did you make a presentation at that meeting? A. Yes.

Q. Was it a formal presentation? A. I think it was more of an informal presentation to update the directors on what has happened since we met last.

Q. Do you recall what you told the directors at that time? A. No.

Q. You were updating them on what had happened. Do you recall anything on what you updated them on? A. No.

Q. Did you present financial data? A. I don't recall.

Q. Did you summarize your discussions with Basic? A. I don't recall.

Q. Who initiated that presentation to the Executive Committee? [188] A. I did.

Q. Just within Combustion how do you put an item like that on the agenda for the Executive Committee? A. How would I do it?

Q. Yes.

Q. I would discuss it with Mr. Santry and he would have to agree that that was something appropriate to bring before the Executive Committee.

Q. In your case, you are not a member of the Executive Committee, is that right? A. That's right.

Q. In that case it wasn't something you would raise in a regular meeting, it was something you had to plan for in advance? A. That's right.

Q. Do you recall preparing any memoranda in connection with that meeting? A. No.

Q. Do you recall making any slide presentation? A. No.

Q. For instance, did you show the Executive Committee the slide presentation that you had made to First Boston in July of 1978? A. I might have. I don't recall, no.

[189] Q. Were any—did you take any notes of that meeting? A. No.

Q. Did any of your people in the Industrial Products Group attend that meeting of the Executive Committee? A. No.

Q. To your knowledge was any memorandum prepared of that meeting other than the formal minutes which I have? A. Not to my knowledge.

Q. Did you discuss—what was the outcome of that meeting? A. I believe the Executive Committee gave its permission to continue in the same way that it had given its permission the first time we got together.

MR. CROSS: Let me have the reporter mark as Plaintiffs' Exhibit 22 a copy of what appears to be minutes of the meeting of the Executive Committee of Combustion Engineering dated July 27, 1978 produced to plaintiffs under the No. CE-2-4.

(Whereupon, a document entitled Combustion Engineering, Inc., Meeting of the Executive [190] Committee, July 27, 1978, No. CE-2-4, was marked Plaintiffs' Exhibit 22 for identification, as of this date.)

BY MR. CROSS:

Q. Mr. Kelly, are these the minutes of that meeting of the Executive Committee that you were referring to? A. (Perusing document.)

MR. STERNMAN: He was referring to a meeting in November—

MR. CROSS: No—

MR. LORENCE: No.

MR. CROSS: I don't know when he was referring to it, he said it was one meeting.

A. Yes.

Q. Is this the meeting you were talking about or some other meeting? A. This meeting.

Q. I notice it is not signed, but does this substantially describe the sense of the meeting as you recall it? A. Yes.

Q. Was that the only topic discussed at that meeting? A. I believe so.

[191] Q. Was that meeting called solely to discuss that topic? A. Yes, I believe so.

Q. What had happened prior to July 27, 1978 which made such a meeting appropriate in your mind? A. I believe we, that I had another meeting with the people from Basic around this time.

Q. And where was that meeting? A. Cleveland.

Q. Do you recall when that meeting was? A. No.

Q. Who attended it? A. I don't recall.

Q. You attended it? A. Yes. Oh, from Combustion?

Q. Did anybody else from Combustion attend it? A. I don't believe so.

Q. You don't recall who attended from Basic? A. No.

Q. Was Mr. Muller there? A. I'm sure that Mr. Muller was there, yes.

Q. Where was the meeting, at Basic's headquarters? A. I'm not quite sure whether the meeting was at Basic's headquarters. Some time around this time we met [192] at the airport, Burke Lakefront Airport, there was one meeting there.

Q. You don't know whether the meeting you are talking about now was that one or some other meeting? A. No.

Q. Do you recall what was discussed at that meeting? A. No.

Q. Did you discuss price at that meeting? A. At some meeting I suggested a price. I don't know whether it was that meeting or some time at some other meeting.

Q. Was that meeting in Cleveland before or after the presentation that you made to First Boston on or about, I guess it would be July 18, 1978? A. I don't recall. * * * *

Q. Was the Executive Committee meeting which is [193] referred to in Plaintiffs' Exhibit 22 the result of your discus-

sions with Mr. Santry on or about July 19, 1978 which is referred to in Plaintiffs' Exhibit 17, specifically Page 2 of Plaintiffs' Exhibit 17 (handing)? A. (Perusing document.)

Q. That is if you recall. A. I don't recall.

Q. Or the result of your discussion with Mr. Calvert on July 20, 1978? A. I don't recall. * * * *

Q. Let me see if I can refresh your recollection.

On Page 3 of the document which has been marked Plaintiff's Exhibit 17, but Page 2 of your memorandum to Mr. Santry dated July 19, 1978 there is a suggestion, the only legible part of the page, there is a suggestion that Mr. Santry may want to discuss the matter with the Executive Committee.

Does that help refresh your recollection as to whether or not the July 27th Executive Committee [194] meeting was a result of this memorandum? A. No.

Q. Following the July 27, 1978 Executive Committee meeting what, if anything, did you do to continue to proceed with your investigations and preparations and as appropriate, negotiations, with respect to Basic? I am quoting from the document. A. I don't recall that anything happened from about that time until the fall of the year.

Q. The fall being August, September?

MR. STERNMAN: That is an early fall.

Q. I say August-September because there is a reference in Plaintiffs' Exhibit 17 to the fact that CE would be making a proposal in August after Mr. Muller's antitrust lawyer returned. A. I don't believe that—there was a period of time of several months starting at about this time, until late in the, I think it is, I don't know specifically, but it certainly would be September-October before we ever, there was ever any contact again. * * * *

[195] * * * * Q. So it is your testimony there was no further contact until, to the best of your recollection, September-October? A. That's right.

Q. You testified last week that the acquisition of Basic had been made an initiative of the Industrial Products Group strategic plan for the plan that was issued in October of 1976.

Let me show you, and have the reporter mark as Plaintiffs' Exhibit 23 an extract from the Industrial Products Group's strategic plan dated September 23, 1977 and produced to plaintiffs as CE-2-3.

(Whereupon, a two-page document entitled CE Industrial Products, Industrial Products Group Strategic Plan 1978-1984, dated September 23, 1977, No. CE-2-3, was marked Plaintiffs' Exhibit 23 for identification, as of this date.)

BY MR. CROSS:

Q. First of all, Mr. Kelly, am I correct that this two-page document does represent an extract from the Industrial Products Group's strategic plan? A. (Perusing document.) Yes, sir.

[196] Q. And it indicates that the major initiative of the prior year had been reproduced and that was to acquire Basic, Inc., and I assume for \$30 million; is that correct? * * * *

Q. That major initiative was continued for the 1978 period by the publication of this strategic plan; is that correct? A. That's correct.

Q. And I take it that the explanation at the bottom of Page 2 of Plaintiffs' Exhibit 23 is in part a rationale [197] for the continuance of that major initiative; is that correct? A. That's right.

Q. Did you discuss that rationale with anyone at Basic at or about the time this strategic plan was prepared? A. I don't believe so.

Q. In your January 12, 1977 meeting with Basic do you recall informing them that you intended to expand into the non-alumina based refractories market?

MR. MADSEN: May he have the question reread, please?

(The record was read.)

A. No.

Q. You don't recall? A. Right.

Q. Do you recall at any time telling Basic that? A. No.

Q. Do you recall discussing with anyone from Basic the economics of entering the non-alumina based refractories market by acquisition versus by internal expansion, internal of Combustion Engineering? A. I don't recall that.

Q. Did you conduct such an analysis? [198] A. Did CE conduct such an analysis?

Q. Yes. A. I don't believe a formal document was prepared, but thinking within our own planning process we came to that conclusion.

Q. Came to what conclusion? A. That the only way to enter this business was by acquisition.

Q. That it was not economically feasible to build your own plant? A. Correct.

Q. And that was based on an analysis of the cost of building a plant in comparison to the market for the product, the anticipated revenue stream from a new plant as compared to the economic cost of building a plant; is that correct? A. That's right.

[200] * * * * Q. Do you know when these notes were prepared. A. No, I don't.

Q. Do you know whether or not they were prepared in 1977? A. Are we talking about the first two pages or the last page?

Q. Let me withdraw that question.

Is the last page, was it prepared at or about the time the first two pages were prepared. A. I can't say.

Q. Is the date on the last page related to the date on the first two pages? A. It seems to be.

Q. Do you recall, when you say it seems to be? A. Well, the only thing, in about the bottom third of the first page it says, earnings are four and a half, four and a half million, and that seems to be the same earnings figure on the last page dated July 12, 1977.

Q. Okay. A. From that I would gather I must have been talking about the same year, whatever year that was.

[201] Q. Do you recall who prepared—directing your attention, as long as we are discussing it, also to Plaintiffs' Exhibit 25 which appears to be the same as Page 3 of Plaintiffs' Exhibit 24, except it has some of your handwritten—let me withdraw that.

Am I correct that the notes on the bottom of Plaintiffs' Exhibit 25 are your handwritten notes? A. That's right.

Q. And do you recall who prepared Plaintiffs' Exhibit 25? A. This document?

Q. Plaintiffs' Exhibit 25 is the single sheet which is also the third sheet of Plaintiffs' Exhibit 24. A. I did.

Q. You prepared it yourself? A. Yes.

Q. Did you prepare it on or about the date it bears, July 12, 1977? A. I believe so.

Q. On Plaintiffs' Exhibit 24 at the top, Page 3, there is a reference, CC ATS and JFG, I think. A. AJS and JFC.

Q. Who are those individuals? [202] A. Arthur J. Santry and James F. Calvert.

Q. Does that indicate you sent this document—I am now referring to Plaintiffs' Exhibit 25 or the third page of Plaintiffs' Exhibit 24—

MR. STERNMAN: Excuse me, why don't you stick with the latter since there are differences, given the handwriting on 25, the question is was the third page of 24 sent to those individuals?

MR. CROSS: Yes.

A. I would say yes.

BY MR. CROSS:

Q. Did you discuss the data on here with either of those individuals? A. Not that I can recall.

Q. Do you recall what the occasion was for your preparing the third page of Plaintiffs' Exhibit 24? A. No.

Q. Do you recall, was it in connection with a meeting that you were having with Basic? A. I don't recall.

Q. Where did the data that is set forth on Plaintiffs' Exhibit 24 come from? What is the source of the data? A. The annual report, I would think.

[203] Q. Basic's annual report? A. Yes. * * * *

A. Excuse me, I thought you were talking about the last page.

The ideas expressed as actions are my ideas. The data came from published documents, I would believe.

BY MR. CROSS:

Q. The earnings per share figures on Page 3 of Plaintiffs' Exhibit 24 for 1977, where did those figures come from? A. I believe those were my estimates.

Q. Estimates? A. Yes.

Q. What was Basic's fiscal year? A. Calendar year.

Q. So the 1977 annual report would not have been out? A. That's right.

Q. Do you recall discussing those estimates with [204] anyone at Basic? A. No.

Q. On Page 3 of Plaintiffs' Exhibit 24 in the column that says premium over seventeen, what does that column refer to? A. That must have been, 17 must have been the market price of Basic at the time this document was drawn up.

Q. And what do the figures under there describe, the 24, the 29? A. Percent premiums.

Q. Percentage premiums? A. I believe so.

Q. Or absolute dollar premiums? A. No, it must have been percent.

Q. And why are there three different sets of values set forth under that column? A. That I believe refers back to the value of CE in the columns, three columns to the left, CE at sixty, sixty-two and sixty-five.

Q. On Page 1 of Plaintiffs' Exhibit 24 I notice that the items set forth are numbered on non-sequence order in the sense that the top item on Page 1 is numbered 2 and the second item is numbered 1 and the third item is numbered 3.

[205] Who numbered those items in that way? A. I did.

Q. Does that represent your set of priorities in expressing these ideas, these are the things that should be done in a certain priority? A. I believe so.

Q. I notice that the item numbered 1 says CE buys 215,000 shares of market of say twenty-two.

To what does that, what does that describe, that statement? A. I don't recall.

Q. What was this sheet? You described Pages 1 and 2 of Plaintiffs' Exhibit 24 as being, I think you said in rough paraphrase, the ideas set forth here are mine, but the data came from the annual report.

What were these ideas being set forth for? A. They were being set forth, my notes of how I thought a transaction could be worked.

Q. A. transaction acquiring Basic? A. That's correct.

Q. Did CE ever attempt to buy shares of Basic at market on the open market? A. No.

Q. Did CE at any time prior to December 18, 1978, * * * *

[219] MR. STERNMAN: I will show him the exhibit (handing).

A. (Perusing document.)

MR. STERNMAN: The question is when that statement was made did they discuss what?

MR. CROSS: Plaintiffs' Exhibit 17 purports to reflect a conversation between Mr. Muller and Mr. Kelly at which Mr. Muller informed Mr. Kelly that his answer to any outside inquiry continues to be that Basic management knows nothing that could be causing the rise.

I am asking whether at the time of that discussion with Mr. Muller, Mr. Muller and Mr. Kelly had any discussion about whether there should be consideration given to disclosure of the discussions between Combustion and Basic.

A. I don't recall that.

BY MR. CROSS:

Q. Do you recall in what context you had this conversation with Mr. Muller, and what prompted you to even discuss the topic? A. I believe his stock was going up in price.

[220] Q. And volume was going up? A. I don't know about volume.

Q. And why was that a matter of concern to you?

MR. STERNMAN: Just a minute now, why don't you ask him if it was a matter of concern.

Q. Was it a matter of concern to you? A. It was a matter of concern to me, yes.

Q. What was it a matter of concern? A. Because we were in my mind at this time talking about a tax free transaction which would be stock for stock and the relationship of the stock price of Basic to Combustion stock was important.

MR. STERNMAN: Excuse me, Mr. Kelly, you used the term we—

THE WITNESS: I.

MR. STERNMAN: Does that mean you and Mr. Muller or does that mean Combustion or does that mean Mr. Kelly in some royal we sense?

THE WITNESS: It means Mr. Kelly.

BY MR. CROSS:

Q. Mr. Kelly and First Boston—

MR. STERNMAN: Just a minute now. He said we were talking and it now sounds like [221] I was thinking—

MR. CROSS: The remainder of this document, Mr. Sternman, Plaintiffs' Exhibit 17, constitutes a slide presentation at which Mr. Kelly is discussing the advantages of a tax free transfer with First Boston and this document is transmitted to Mr. Santry.

MR. STERNMAN: I understand all that, I am just telling the witness that his use of the phrase we were talking, in that answer, is ambiguous, and that he might want to clarify.

THE WITNESS: Shall I?

MR. STERNMAN: Yes. Let's hear the answer back.

(The record was read.)

A. In my mind I was thinking we were looking towards, or in my mind I was looking towards a stock for stock transaction, and the price of Basic stock in relation to Combustion stock was very important.

BY MR. CROSS:

Q. In what sense was it important? A. It was important because in order to make an offer, if we made an offer that would be acceptable to [222] the stockholders of Basic, there would have to be a premium.

Q. And at some Basic-Combustion ratios that premium would become excessive? A. Not the premium would become excessive, the dilution of Combustion's earnings would be such that we would not make an offer.

Q. Did you have in your mind at the time of this conversation with Mr. Muller what level of Basic, at what level Basic's price, Basic's stock price would make such a tax free exchange unattractive? A. No.

Q. Did you express these concerns to Mr. Muller? A. No.

Q. But that was the basis on which you called Mr. Muller and raised this topic, on or about July 19, 1978? A. What basis, what was the question?

Q. The concern about the price of Basic stock was what prompted you to have this conversation with Mr. Muller? A. I believe so, yes. • • • •

[301] • • • • BY MR. CROSS:

Q. Your testimony earlier was you don't recall specifically the discussions about SIC Codes? A. I recall, we discussed SIC Codes. Exactly when it was, I don't recall.

Q. Do you recall suggesting that the CE lawyers and the Basic lawyers get together to discuss the FTC? A. Yes, I believe so.

Q. Do you know whether or not that happened? A. It did not, I don't believe it happened. • • • •

[307] • • • • MR. CROSS: What?

MR. STERNMAN: Should he read the entry for that day?

MR. CROSS: I am asking first of all if he recalls a call—

A. No.

MR. CROSS: I will have the reporter mark as Plaintiffs' Exhibit 45 a five-page document headed Basic Inc. Assumptions and Information.

(Whereupon, a five-page document entitled Basic, Inc., Assumptions and Information, No. B-4-11 was marked Plaintiffs' Exhibit 45 for identification, as of this date.)

MR. CROSS: The number is B-4-11 and it is similar to Exhibit—

MR. STERNMAN: Similar to Exhibit 15. • • • •

[308] • • • • Q. My question is: What was the occasion for your delivering this document to Basic on June 7, 1978?

The reference in the upper right-hand corner of this document indicates received from JK 6/7/78 and first of all, do you recall delivering this document to somebody at Basic in the June 7th meeting in 1978? A. I believe this was part of the package of financials that Mr. Insley prepared. I believe this was the meeting that he missed.

Q. And you delivered a package of financials to Basic? A. I believe so, yes.

Q. Do you recall what else was in that package? A. I believe that—I believe that the put-together data of the two refractory companies was part of it.

Q. Anything else? A. Not that I recall. • • • •

[355] BY MR. ELKIND:

Q. Mr. Kelly, during the period 1966 through 1976, did you continue to have an interest in Basic? A. Yes, off and on.

Q. And was the reason that you did not pursue that interest with Basic at that time because there were antitrust problems? A. Yes.

Q. Was there something that happened in 1976 that changed that situation? A. Something happened around that period of time, yes.

Q. What was that? A. The government brought some sort of action against Kaiser for its acquisition of Lavino, both refractory companies.

Q. This is the proceeding that has been referred to as the Kaiser-Lavino proceeding? A. I think so.

Q. How did you become aware of the Kaiser-Lavino proceeding? A. I don't recall.

Q. Did you testify in connection with the Kaiser-Lavino proceeding? [356] A. I think somebody asked me some questions about it.

MR. JEAVONS: You mean at this deposition in a prior session?

MR. ELKIND: No.

Q. Did you testify before the FTC in connection with the Kaiser-Lavino proceeding? A. No.

Q. Did other people from Combustion testify before the FTC? A. Yes.

Q. Who were these persons? A. Mr. Hegeman.

Q. Could you identify him? A. He's the head of the refractory division.

Q. Did Mr. Caito testify, to your knowledge? A. He may have.

Q. Do you recall when Mr. Hegeman testified before the FTC? A. No.

[378] * * * * and Mr. Ludwig at that time about how Basic would fit into the Combustion family after an acquisition? A. I don't recall that Mr. Ludwig was in the meeting.

Q. Do you recall talking with Mr. Muller about that? A. Yes. * * * *

[379] * * * * Q. I direct your attention to Pages 63 through 64 of the transcript, specifically at the bottom of Page 63, which says, and I quote:

"Question: Could you answer the question?

"Answer: I don't recall specifically, but, in each of these meetings, I was explaining to them how we operated companies like Basic after acquisition.

"Question: I didn't hear you.

"Answer: I was telling him how we operated companies like Basic after acquisition. I explained that they would continue as separate entities within our operation."

MR. STERNMAN: Let me suggest that you also look at my comment at Lines 17 through 21 of Page 64 which indicated that Mr. Kelly may have been testifying about discussions during the period and not necessarily about the October, the [380] pre-October 1976 meeting.

Q. For my first question:

Does the testimony that I just read to you fairly and accurately represent your testimony before the SEC? A. Yes.

Q. When you were referring to each one of the meetings on Lines 24 and 25 of Page 63, were you referring to the meetings which took place throughout the period between 1976 through 1980? A. In general, yes.

MR. STERNMAN: 1978?

Q. 1976 through 1978? A. Yes.

Q. Mr. Kelly, I show you the November 18, 1976 Executive Committee minutes that were marked at your SEC deposition as Kelly Exhibit 7, and I direct your attention to Page 77 of your testimony.

MR. STERNMAN: What would you like him to do?

Q. Mr. Kelly, the transcript of your testimony says, and I quote:

"Question: This Executive Committee meeting of November 18, 1976, who initiated this [381] meeting?

"Answer: I did.

"Question: You did?

"Answer: Yes.

"Question: Was this a specially-called meeting to discuss this subject?

"Answer: Yes.

"Question:" —

MR. STERNMAN: Let me note the question says, "Was this a specially-called meeting to discuss this subject?"

Q. (Continuing)

"Answer: Yes.

"Question: The purpose of this meeting was to discuss Basic Incorporated?

"Answer: That's correct.

"Question: Were there any other purposes?

"Answer: No."

Does that fairly and accurately reflect your testimony before the SEC? A. Yes. * * * *

* * * * Q. Mr. Kelly, directing your attention to Kelly Exhibit 3 in your—to your SEC testimony, and to the meeting that is referred to on June 24th between yourself and Mr. Muller, can you tell me what transpired during that meeting? A. From my memory, no. * * * *

[446] * * * * Q. Mr. Kelly, I direct your attention to the document that was marked at your SEC testimony as Kelly Exhibit 11. You can have this before you.

I believe you have testified earlier, Mr. Kelly, that this document relates to a possible—relates to computations you made in considering the possible acquisition of Basic, is that right? A. Yes.

MR. STERNMAN: You are asking if he testified in this case. If you are going to do that, would you refer—

MR. ELKIND: Let me rephrase it.

Q. Kelly Exhibit 11 of the SEC testimony, a July 12, 1977 memo relates to calculations you made of possible acquisition by Combustion of Basic, is that right? * * * *

[447] * * * * BY MR. ELKIND:

Q. What does Kelly Exhibit 11 refer to, the memorandum dated July 12, 1977? A. (Perusing document)

It appears to be some assumptions on various exchange rates that might go forward as a basis for an offer to Basic looking toward an acquisition.

Q. You mean an offer by Combustion to acquire Basic? A. Right.

Q. Were you considering in these calculations a stock-for-stock transaction or a cash transaction? A. It looks like stock for stock.

Q. Under the heading "premium over 17," could you explain to me what the numbers 29, 29, 35, 41, 47 and 53 refer to?

You don't have to tell me what those specific numbers are, but just tell me what they refer to, what they mean. * * * *

[448] * * * * A. (Perusing document)

That would appear to be—I am not sure about this—but it would appear that maybe Basic was selling for around seventeen dollars a share, and that at these three columns of exchange rates, these three columns of values, 60, 62 and 65 for Combustion, and these exchange rates, these would be the premiums that would be generated over 17 percentage-wise.

That is my, without a long analysis, I would think quickly that's what it means.

BY MR. ELKIND:

Q. In other words, the calculations underneath the heading of Premium show the percentage premium over the market price of Basic stock that the various exchange ratios that you were considering would refer to? A. Yes. * * * *

[449] * * * * A. The calculations, that's right.

Q. And the premiums you were considering in doing the calculations in the memorandum were the premiums over the market price of Basic were 29 percent, 35 percent, 41 percent, 47 percent and 53 percent, is that right?

MR. STERNMAN: I don't think he was considering those percentages. That is what computed out.

A. That's what the table would show.

Q. In other words, the exchange rates— A. These exchange rates at these CE values were generating these premiums over a market price of seventeen.

Q. In other words, the exchange rates you listed in the column at the left at the Combustion Engineering per share values listed under heading of Value, that you listed under the heading of Value, [450] would result in the premiums that were listed under the heading of Premium over seventeen? A. Right.

Q. And those premiums over the market price of Basic would range from twenty-nine percent to fifty-three percent, is that right? A. No, really range from fifteen percent because apparently from looking at this after I did this memo up, the stock must have dropped and—

Q. CE stock? A. CE stock must have dropped off, so I put down these two lower values, which generated the lower premiums.

So the premiums would range in this table from fifteen to fifty-three.

Q. So you first had a set of typed calculations? A. Yes.

Q. And that shows from twenty-nine to fifty-three percent? A. Right.

Q. And then the handwritten calculations based on the decline of the market price of Combustion Engineering stock—

[451] * * * * A. That's my belief, yes.

Q. And those premiums— * * * *

* * * * Q. The premiums that you computed based upon a decline in the market price of CE stock range from fifteen percent to thirty-six percent, is that right? A. That's correct.

Q. Mr. Kelly, let me show you the document that was marked as Kelly Exhibit 12 at your SEC * * * *

[455] MR. ELKIND: On the record.

BY MR. ELKIND:

Q. Mr. Kelly, I direct your attention to the document that was marked at your SEC testimony as Kelly Exhibit 14, which is a two-page document which appears to be a chart, a handwritten chart of some kind.

And if you look at the bottom in here it says, at the bottom, the date is October 12, 1977. A. (Perusing document) Yes.

Q. Do you recall preparing the chart that has been marked, that was marked as Kelly Exhibit 14 at your SEC testimony?

* * * * Q. Do you recall preparing the chart that was marked as Kelly Exhibit 14 at your SEC deposition? [456] A. Yes.

* * * * Q. Do you recall preparing the chart that was marked as Kelly Exhibit 14 on or about October 12, 1977? A. No.

Q. You do not recall preparing that chart? A. On or about, I don't remember when I prepared it. It's in my handwriting, though.

Q. Did you prepare the chart? [457] A. Yes. * * * *

Q. Can you tell me when you prepared the chart? A. No.

Q. Can you tell me why it says October 12, 1977 at the bottom; there is writing at the bottom that says "Jim Kelly chart," with an arrow pointing to October 12, 1977. A. I didn't write that October 12, 1977.

Q. Did you write the words "Jim Kelly chart"? A. No, that's not my handwriting.

Q. Do you know whose handwriting it is? A. No.

Q. Do you recall—

MR. STERNMAN: I do not know if this will assist, but Mr. Muller's chronology reflects—these are Mr. Muller's notes now—reflects some visit by Mr. Kelly in Cleveland on October 12, 1977, states, "Talked in general about CE and Basic."

I think there has been testimony from Mr. Kelly about that meeting to the effect that he does not recall anything that happened at it.

[458] * * * * Q. Do you recall the circumstances under which you prepared the chart? A. No, but I think it must have been at the meeting itself.

Q. Can you describe for me what the chart is? A. The chart is, shows the organization of the Industrial Products Group as it existed at the time, and also shows where Basic would go if [459] Basic were acquired by Combustion. * * * *

[460] * * * * Q. Mr. Kelly, I direct your attention to your testimony on Page 145 of the transcript before the SEC. A. Yes.

Q. Referring to Line 6, it says:

"Question: This is marked as Kelly Exhibit No. 14. I will ask you if you've ever seen this before?

"Answer: It is my handwriting.

"Question: What does it represent?

"Answer: An organizational chart that explains to the Basic people how they would fit into the organization. As I said before, they would be on the same level as the refractories and metals."

Does that fairly and accurately summarize your testimony before the SEC? A. Yes.

Q. Do you recall discussing with Mr. Muller at or about the time—

MR. STERNMAN: You said—

Q. Do you recall discussing with Mr. Muller or Mr. Ludwig at or about the time you prepared this * * * *

[467] MR. ELKIND: Let's go off the record a minute.

(Discussion off the record.)

MR. ELKIND: On the record.

BY MR. ELKIND:

Q. Do you recall Mr. Muller saying, "not yet"? A. No.

Q. I direct your attention to another entry for February 6, 1978 in Plaintiffs' Exhibit 20 for ID which says, and I quote: "MM called Kelly, told him of impending visit by Peter Goodall and Derik Booth."

Do you recall that conversation? A. I do recall at some time he called me to tell me that these two gentlemen were coming to see—

Q. Do you know who Peter Goodall and Derik Booth are? A. They are from Hepworth.

Q. Did you know either of the two gentlemen? A. I may have met either or both of them many years ago. * * * *

[477] * * * * BY MR. ELKIND:

Q. Mr. Kelly, let me show you Plaintiffs' Exhibit 210 again, and I show you the document that was marked as Kelly Exhibit 16 at your SEC testimony. A. (Perusing document) Yes.

Q. This refers to a meeting which took place in Cleveland on June 7, 1978 between yourself, Mr. Muller, Mr. Caito and Mr. Ludwig? A. Right. Do you want me to read it?

Q. No— * * * *

Q. I direct your attention to Pages 180 to 181 of your testimony before the Securities and Exchange Commission, and I refer you to Line 12, and I quote:

"Answer: Right. I believe that's the meeting that Mr. Insley was going to attend and be available to talk about these financials, but [478] I was to pick him up in North Philadelphia and then go on to Cleveland in the company plane, and when we arrived over North Philadelphia, it

was too foggy to land. So I believe that's when he was scheduled to attend, but we couldn't pick him up because of fog.

"Question: Who initiated this meeting between you and Mr. Muller?

"Answer: I don't recall.

"Question: What was the purpose of this meeting?

"Answer: To review the financials of the combined companies.

"Question: Was there any other purpose other than to review the financial data?

"Answer: No.

"Question: What did you do to prepare for this meeting?

"Answer: I read Mr. Insley's financials."

Does that fairly and accurately represent your testimony before the SEC? A. Yes. * * * *

[485] "Mr. Sternman: And up to"—

MR. STERNMAN: You can skip the colloquy unless you think it is necessary, or you can read it.

MR. ELKIND: Let me skip the colloquy.

Q. It goes on, and I quote:

"The Witness: I believe that sometime after the meeting they did some analysis work for us, and I think that was the first time they ever brought up the possibility of a part stock, part cash transaction."

Then it goes on, beginning Line 23, and I quote:

"Question: You say sometime after the June 1978 meeting they did some analysis. Can you put that in any more specific time frame?

"Answer: I believe we had an Executive Committee meeting sometime along the way. Is that right?

"Mr. Sternman: Yes.

"The Witness: That probably was in preparation for that July 27th."

And then beginning Line 11, it says, and I quote:

[486] "Question: The July 27, 1978 Executive Committee minutes, do they refresh your recollection as to when you next contacted First Boston Corporation?

"Answer: I believe it was prior to this meeting, and probably in preparation for this meeting."

Does that fairly and accurately summarize your testimony before the SEC? A. Yes.

Q. Is the work that First Boston did for you that you are referring to in that testimony before the SEC the First Boston Corporation report dated July 14, 1978? * * * *

[488] Q. * * * * Let me try to improve upon your counsel's phraseology.

Is the work that was prepared by First Boston Corporation in which they first suggested a cash deal with Basic the work that you referred to in your testimony before the SEC, is that work the report dated July 14, 1978?

MR. STERNMAN: Where is the reference [489] in the SEC testimony? I lost it.

MR. ELKIND: Page 196, beginning Line 18.

MR. STERNMAN: The question is in the testimony given by Mr. Kelly at Page 196, Lines 18 through 21—was he referring to Kelly Exhibit 17?

MR. ELKIND: That is the report dated July 14, 1978.

A. Yes, but I think I characterized that as a document in which they first suggested a cash deal. I don't believe they are suggesting that.

BY MR. ELKIND:

Q. Well—

A. They are setting forth various alternatives.

Q. Under the heading "Merger Consequences," the three alternatives they have are a hundred percent common stock, right, a hundred percent—

MR. STERNMAN: I think the ambiguity is the word suggesting.

A. They are doing some analyses. What their suggestion was, I don't know, their recommendations, I don't know what this recommended.

Q. But they were doing analyses of a hundred [490] percent common stock, a hundred percent cash or combination of stock and cash, is that right? * * * *

* * * * Q. When you say they were doing analyses of alternatives, you were referring to those alternatives, were you not?

MR. STERNMAN: What testimony are you referring to?

MR. ELKIND: The witness says First Boston was doing analyses of various alternatives, and not suggesting anything.

BY MR. ELKIND:

Q. I say, when you refer to analyses of alternatives, the alternatives they were doing analyses of were 100 percent stock, 100 percent cash or a combination of stock and cash? A. Yes.

[499] * * * * A. There were certain actions that counsel was going to take which would use up the time between July 19th and the middle of August.

BY MR. ELKIND:

Q. Do you recall Mr. Muller informing you that his antitrust lawyer was on vacation and would be on vacation for some time? A. I believe I do recall that.

Q. Why were you going to speak with Mr. Muller's antitrust lawyer?

MR. STERNMAN: Mr. Kelly, personally?

Q. Either you or Combustion Engineering counsel. A. To make sure that the Basic outside counsel agreed with our counsel that there were no antitrust problems.

Q. Did you talk with Mr. Muller about setting [500] up a meeting between counsel for Basic and counsel for Combustion? A. There was—I think we tried to set a meeting like that.

Q. At what point in time did you try to set up a meeting? A. Around this time period. I don't know it specifically.

Q. Let's get back to the July 19, 1978 memo. As of the time of that memo, there was a discussion about getting the lawyers for Basic together with the lawyers from Combustion, was there not? A. I believe so, around that time, yes.

Q. And that was something that was going to take some time, was it not? A. Correct.

Q. And when you wrote, "What this means is that we will not make any proposals to Basic until mid-August at the earliest," is that part of what you were referring to? A. Yes.

Q. Was there a discussion about a communication with the Federal Trade Commission? A. That possibility was discussed.

[501] Q. With whom was it discussed? A. I believe—

MR. STERNMAN: I caution you, Mr. Kelly, you are not to reveal any communications between you or other CE representatives and their counsel in giving this answer.

So if you have reference to a discussion with Mr. Muller, you should testify to that, but not any conversation with CE counsel.

A. I believe I talked to Mr. Muller.

Q. You talked with Mr. Muller about a joint submission to the FTC? A. I believe we discussed that as a possibility.

Q. What was said along those lines? A. I believe we left it, it was up to the lawyers to decide what they wanted to do.

Q. What kind of a submission did you talk about making? A. We didn't talk about anything specific as far as I can recall.

MR. STERNMAN: By submission, in your prior question, did you mean some [502] formal submission or something more like a visit or an approach?

MR. ELKIND: Either.

MR. STERNMAN: I have not seen anything—how did you understand the question?

BY MR. ELKIND:

Q. What kind of joint approach—

MR. STERNMAN: Excuse me.

There was a prior question about a submission to which you responded affirmatively. How did you understand the reference to submission?

MR. ELKIND: Let me try to clarify that, I think my questions will make it clearer.

Q. Did you talk with Mr. Muller about making a joint submission of some form of documents? A. I don't believe so.

Q. Did you talk with him about making a joint approach in terms of research and some form of verbal presentation to the Federal Trade Commission? A. I don't think we talked about the specifics of what the lawyers would recommend that we do.

[503] Q. You talked about the subject of an approach in general? A. I think I recall something like that.

Q. And the idea was first the lawyers on each side would take a look at the antitrust consequences? A. Our lawyers already had.

Q. What about Basic's lawyers? A. I don't know what their status was.

Q. Did Mr. Muller tell you what the status was of their investigation as of July 19, 1978? A. I don't recall.

Q. Then after each side had done its homework, the lawyers, the idea was the lawyers would get together, is that right? A. Yes, that was my understanding, that they would get together either in person or by telephone.

Q. And they would then decide what form of approach to make to the Federal Trade Commission? A. If any.

Q. If any, is that right? A. That's right.

Q. Is Mr. Cy Lewis counsel for Combustion Engineering?

[504] MR. STERNMAN: Cy Lewis is a partner of my firm.

Q. Mr. Bill Huth is inside counsel for Combustion? A. Correct.

Q. Do you know whether there were, in fact, communications between counsel for Basic and counsel for Combustion following this July 19, 1978 memo? A. I don't recall.

Q. Do you know whether there was an approach made to the FTC? A. There was not.

Q. There was not? A. Right.

Q. Was there a decision made not to make an approach to the FTC? A. I guess there was if no approach was made.

MR. ELKIND: Off the record.

(Discussion off the record.)

MR. ELKIND: On the record.

BY MR. ELKIND:

Q. Can you tell me when that decision was made not to approach the FTC?

[505] MR. STERNMAN: I think that the witness has assumed that there was an affirmative decision made not to approach the FTC.

Q. Do you know whether there was an affirmative decision made not to approach the FTC? A. I believe the lawyers were in some sort of contact and they agreed not to do it.

Q. Do you know when they reached that agreement? A. No.

Q. Was it following the July 19th meeting? A. Yes.

Q. In August—

MR. STERNMAN: What July 19th meeting?

Q. Was it following the July 19, 1978 memorandum?
A. Yes, I believe so.

Q. Was it sometime in August? A. I don't know.

Q. September? A. I don't know.

Q. October? A. I don't know. * * * *

[512] * * * * Q. Do you recall how you became aware that the proceeding had been decided? A. No.

Q. The Kaiser-Lavino proceeding? A. No.

Q. You do not recall whether you were advised of it by someone from Combustion or somebody from Basic or by counsel? A. I can't say specifically.

Q. Do you know whether inquiries were made between July and October 1978 as to the status of the FTC proceeding? A. No, I don't.

Q. Do you know whether anyone was asked to make inquiries of the FTC as to the status of the Kaiser-Lavino proceeding? A. I don't know.

Q. Mr. Kelly, I direct your attention to [513] Page 246 of your testimony before the Securities and Exchange Commission. A. (Perusing document)

Yes.

Q. And specifically to Lines 18 through 21 in which you testified, and I quote:

"As I recall, that"—referring to the decision of the FTC in the Kaiser-Lavino case—"probably was one of the main reasons for our taking the action at this time. We were advised that this would be a good time from that aspect of the acquisition to get it done."

MR. STERNMAN: In fact, that ties right into the question that I suggested that you ask Mr. Kelly, which is whether at the time of the November 27 meeting he was aware that the Kaiser-Lavino decision had come down.

For some reason you declined to ask that, and asked another—a whole bunch of other questions which did not bring that out. * * * *

[532] Q. Do you know that there were no discussions with Mr. Muller or Mr. Ludwig in December of 1978? A. No.

Q. And does the same hold true for October of 1978? A. That's correct.

Q. Do you recall—

MR. STERNMAN: Mr. Kelly, let me ask you a question right now.

Do you have any recollection of having any such conversations during August, September or October 1978?

THE WITNESS: I believe there were no conversations because I was embarrassed to call Basic back in the fall of the year because I hadn't gotten back to them.

BY MR. ELKIND:

Q. Isn't it a fact that you spoke with Mr. Ludwig in September 1978? A. I don't recall that.

Q. At or about the time that the September 1978 press release was issued by Basic? A. I don't recall that. * * * *

**Excerpts from the Examination of James B. Kelly
by the SEC**

[58] * * * * MR. WACHTERMAN: Is it possible the subpoena did not reach them at that time? This is through December, 1978.

MR. STERNMAN: This is through December of 1978. The answer is no.

BY MR. MEADOWS:

Q. In this meeting with Mr. Muller, what was discussed, Mr. Kelly? A. The meeting—

MR. STERNMAN: I'm confused. May we clarify this? This is a meeting in 1976 between Mr. Muller and Mr.

Kelly. This is the first meeting following the renewal of interest, Mr. Meadows?

MR. MEADOWS: Yes.

MR. STERNMAN: Have you a recollection of this, that such a meeting took place in 1976?

THE WITNESS: Yes. I'm sure there was a meeting prior to this letter of October 18.

MR. STERNMAN: That's the meeting about which you will testify.

THE WITNESS: Yes.

BY MR. WACHTERMAN:

Q. Who was present at that meeting? A. I don't know specifically, but at least Max Muller.

[59] * * * * Q. Had you discussed that proposed or future meeting with Mr. Santry? A. Yes. I discussed a continuing contact with him at the time.

Q. Did you discuss that with anybody else at Combustion Engineering? A. I don't think so.

Q. Prior to that meeting had you ever made any presentation of had any contact with the board of directors at Combustion Engineering or any committee thereof concerning the possible interest in Basic? A. No.

Q. At the meeting with Mr. Muller, what at the time was discussed? A. What I was interested in getting from Mr. Muller was a breakdown of his business for the review of counsel. I believe that he gave me the 1976 breakdown at this meeting. Subsequently, I asked for the 1975 breakdown.

* * * *

[60] * * * * Q. What else was discussed at that particular meeting? A. I can't say specifically. Their attitude was that they were not interested in being acquired. But if anyone ever came after them, they would look favorably to getting together with us.

Q. When you say if anybody ever came after them, what do you mean? A. An aggressive or undesirable acquisition attempt at the time.

Q. What did you indicate to Mr. Muller during this meeting was Combustion Engineering's interest? A. That we were interested in talking to them about a possible acquisition. His response was always that he did [61] not want to have any discussions on the negotiations on the acquisition.

Q. Did he say why? A. They were interested in staying independent at the time.

Q. Again, referring to the meeting in 1976 preceding the October 18, 1976, letter. A. Yes.

Q. What was your continued interest in Basic? Why did you have a continued interest in Basic, Incorporated, if they were indicating at this time that they were not interested in being acquired by Combustion Engineering? A. I thought, over a period of time, I could convince him to become interested.

* * * *

[63] * * * * Q. Did you discuss with him the possible price range that such an acquisition could be at? A. Price range?

Q. Yes. A. I don't think so.

Q. Had you, prior to this meeting, at any time had any such discussions with Mr. Muller? A. No.

Q. You talked about a two-hour time range for this meeting. A. Yes.

Q. At the time? A. Yes.

Q. What did you discuss beside asking him for the breakdown? A. For the breakdown?

Q. Yes.

MR. WACHTERMAN: Off the record.

(Discussion off the record.)

MR. WACHTERMAN: On the record.

BY MR. WACHTERMAN:

Q. Could you answer the question? A. I don't recall specifically, but, in each one of these meetings, I was explaining to them how we operated [64] companies like Basic after acquisition.

Q. I didn't hear you. A. I was telling him how we operated companies like Basic after acquisition. I explained that they would continue as separate entities within our operation.

Q. Did Mr. Muller ask you any questions along the lines of how a merger would be effected or the situation after the merger? A. No.

Q. What did you tell him as to how you operated companies after the acquisition? A. That a company as large as Basic would operate as a separate entity, reporting to me on the same level as our refractories and minerals business.

MR. STERNMAN: Excuse me a minute.

MR. WACHTERMAN: Yes.

MR. STERNMAN: The witness' prior answer had referred to many of these meetings. It is not clear to me now whether you want him, generally, to describe this area in the period 1976, 1977 or 1978, or if you have now returned to the year 1976?

MR. WACHTERMAN: No. I'm still with this meeting that had occurred sometime prior to October 18, 1976.

THE WITNESS: I couldn't say specifically. * * * *

[70] * * * * Q. Was there anybody on your staff that had any responsibility concerning Basic, Inc.? A. No.

Q. This was strictly something you did? A. It was my project. * * * *

[82] * * * * Q. Did you tell the meeting of November 18, 1976, what Basic's position was with respect to a possible acquisition? A. Yes. It was that they wished to remain in independent company.

Q. You told them that? A. Yes.

Q. Did you tell them that they had an interest in Combustion Engineering possibly taking them over as an alternative to an unfriendly takeover? A. I can't recall.

Q. Was there any other mention of the possible price at which Basic might be acquired other than the figures that are here? A. No. * * * *

[91] * * * * Q. What was Mr. Muller's and Mr. Ludwig's response to [92] this meeting? In other words, what did they say in response to what you said? A. As far as I can recall, it was the same response that they had made previously. They liked being independent at the time.

Q. Did they say anything else other than they liked being independent? A. No.

BY MR. WACHTERMAN:

Q. Up until this time, up until January 12, up to, and including January 12, 1977, had anyone from Basic, Mr. Muller, Mr. Ludwig, or anyone else, indicated or ever given any set of circumstances, aside from an unfriendly takeover, any other set of circumstances under which they might be considered being acquired by Combustion Engineering? A. I think they may have said—well, actually, they did say that, certainly, if the price were high enough, something to that effect.

Q. Up to, and including January 12, 1977, that meeting with Basic, had you ever mentioned anything about a possible price? A. I don't think so. * * * *

[94] * * * * Q. You indicated earlier when I asked you about a set of circumstances where Basic might have been amenable to being acquired, that somebody said something about some price that we might be amenable to being acquired, or words to that effect. A. Yes.

Q. In that context was any price mentioned? A. I don't believe so.

Q. To the best of your recollection, as of January 12, 1977, no price had ever been mentioned at which Basic might be acquired by Combustion Engineering between you and the people from Basic? A. Not that I recall. * * * *

[96] * * * * Q. Subsequent to the January 12 meeting and their statement that they would talk informally with outside directors, did they, in fact, get in touch with you to tell you what the response was from their outside director? A. In some way or other we did communicate. Probably it was a phone call one way or the other to follow up on the proposed meeting. But they decided not to have the meeting, not to come.

Q. Had a time or place been set for that proposed meeting? A. I suggested they come to Stamford.

Q. Stamford? A. Yes.

Q. And they declined to do that? A. Yes. * * * *

[124] BY MR. WACHTERMAN:

Q. Were you doing any work on the possible acquisition, Mr. Kelly? A. I had hoped that our meeting in January would result in a continuing get-together in Stamford, but that did not happen. I felt that things had sort of slowed down. * * * *

[145] (Kelly Exhibit No. 14 was marked for identification.)

BY MR. WACHTERMAN:

Q. I'm going to hand you a one-page document. A. Yes.

Q. This is marked as Kelly Exhibit No. 14. I will ask you if you've ever seen this before? A. It is my handwriting.

Q. What does it represent? A. An organizational chart that explains to the Basic people how they would fit into the organization. As I said before, they would be on the same level as the refractories and metals.

Q. What were the circumstances surrounding your drawing up that chart? A. I don't recall.

Q. Do you know when you drew it up? A. No.

Q. Was it at a meeting or was this at your office, Mr. Kelly? A. It must have been at a meeting because, if I were going to draw it up ahead of time, well, it is something I sketched out at the time on a piece of paper in Max's office. I gave it to him.

Q. The date on the chart is October 12, 1977. [146] A. Yes.

Q. Does that refresh your recollection as to any meeting that you had during this time period with anybody from Basic, Inc.? A. No.

MR. STERNMAN: Mr. Kelly, is the date of that in your handwriting as well?

THE WITNESS: No.

BY MR. WACHTERMAN:

Q. It is not in your handwriting? A. No.

Q. That date isn't? A. No.

Q. Is there anything else on that chart not in your handwriting? A. That's not. (indicating)

Q. What is that? A. SPO.

Q. Anything else? A. This other is not my handwriting. It says "Jim Kelly—chart." There is an arrow down to a date, which is October 12, 1977.

Q. Is there anything else on that chart that is not in your handwriting? A. These numbers over here. * * * *

[151] * * * * Q. Was there any time when you were told by anyone else at Combustion Engineering that this was not something that the company was interested in doing?-

A. There were people in the company that were not interested in doing it. I had two selling jobs. It was to sell Basic and to sell C.E. management. * * * *

[166] * * * * Q. Was anything else discussed that you can recall at that meeting? A. I believe that was the meeting at which they first suggested the possibility of Basic acquiring our refractory division.

Q. And I think I understand, but I want to make sure, what was your response to that suggestion? A. That I would be glad to explore this alternative. * * * *

[168] Q. In connection with the possibility of Basic acquiring your refractories division was it relevant, were Basic's sales and earnings figures, either past or projected, relevant to that decision? A. The decision as to whether or not we would sell?

Q. Yes. A. It would depend upon what kind of a purchase price we were going to get. The possibility that I was considering at that time was receiving cash or stock in Basic.

Q. And with respect to those possibilities were Basic's past and projected sales and earnings figures relevant information? A. Yes. * * * *

[172] * * * * BY MR. MEADOWS:

Q. During this Burke Lake Airport meeting was there any discussion during that meeting of Combustion Engineering acquiring Basic? A. Not that I specifically recall.

Q. Do you have a general recollection of that subject being broached? A. Well, I think every meeting was for, in my mind, the purpose of trying to be in a position to acquire Basic. I don't know what was in their mind. * * * *

[180] A. No.

Q. Do you have a recollection of any correspondence? A. No.

Q. During that time period.

The memo sets forth certain people that were present: yourself, Mr. Muller, Mr. Caito, Mr. Ludwig, Mr. Arnholt and Mr. Gates. Do you recall anyone else being present for part of that meeting? A. I think Arnholt and Gates were not at the meeting. They were at lunch.

Q. But not the meeting? A. Right. I believe that's the meeting that Mr. Insley was going to attend and be available to talk about these financials, but I was to pick him up in North Philadelphia and then go on to Cleveland in the company plane, and when we arrived over North Philadelphia, it was too foggy to land. So I believe that's when he was scheduled to attend, but we couldn't pick him up because of fog.

Q. Who initiated this meeting between you and Mr. Muller? A. I don't recall.

Q. What was the purpose of this meeting? A. To review the financials of the combined companies.

Q. Was there any other purpose other than to review the financial data? [181] A. No.

Q. What did you do to prepare for this meeting? A. I read Mr. Insley's financials.

Q. Did you do anything else? A. Not that I recall.

Q. Did you have any discussion with anyone else at Combustion Engineering prior to this meeting? A. Not that I recall.

BY MR. WACHTERMAN:

Q. Did you have any discussion with First Boston prior to this meeting concerning the up-coming meeting? A. I don't think so.

Q. At the meeting did you discuss a price at which Combustion Engineering might acquire Basic, Inc.? A. The memo states that I suggested that we consolidate by buying, C-E buying Basic, and I thought that a 28-dollar-per-share cash—

Q. There's no need to read the memo. Is that your understanding of what happened? Is that your recollection, as refreshed, obviously, by the memo? A. I don't recall specifically, but my belief is that if I recorded it this way, this is the way it happened.

Q. This 28-dollar price, how did you come up with that price? A. I don't recall right now.

[182] Q. Had you discussed the 28-dollar price with anybody at Combustion Engineering prior to discussing it with people at Basic? A. I don't think so.

Q. Had you discussed the 28-dollar price with anybody else prior to discussing it at the meeting with Basic? A. I don't believe so. This 28-dollar price that I was suggesting to them was one that I said I would be in a position personally to recommend to Mr. Santry. It was not an offer from Combustion.

Q. But you hadn't discussed it with Mr. Santry prior to that time. A. No.

Q. What kind of calculation, if any, led you to come up with that price? A. I don't recall.

Q. Was there anything in writing which you produced that developed the 28-dollar price? A. I don't recall.

Q. Prior to this meeting on June 7, 1978, had you ever mentioned any other price to anyone from Basic? A. I don't believe I did. * * * *

[239] * * * * Q. Mr. Kelly, subsequent to the July 27, 1978 executive committee meeting what were the next action or actions which you took or were aware of other people taking in connection with discussions with Basic about possible merger? A. I believe that from about the time of that executive committee meeting until late in November we had little if no contact with Basic because of the run-up in their stock price. In fact, when I finally did get back to them in November they wanted to know where I was all summer. * * * *

[245] * * * * Q. What were the circumstances surrounding the arrangement for a late November 1978 meeting with Basic? A. You mean how did it come about?

Q. Yes. A. Well, I was sort of embarrassed not getting back to them, so I probably called them up and said let's get together.

Q. What, if anything, had changed to—well, were the reasons for not having the contact during that period in any way changed in connection with your having contact—had the circumstances changed leading you to have that contact? A. I don't really remember now whether the stock had dropped off or not and I felt I could go back to them or not. I don't know of any other change that had taken place.

Q. Did you initiate a call to Mr. Muller at Basic to arrange that meeting? A. I would think so. I don't recall, but that's how things happened.

[275] * * * * Q. What happened after November 27, 1978? A. I initiated the First Boston meeting which I described, and then subsequent to that it's my recollection that First Boston came to Stanford to make a presentation to Mr. Santry and others.

Q. When was that presentation? A. I don't recall specifically.

Q. With relation to the December 14, 1978 executive committee meeting? A. It would be just prior to that, within days, I would think.

Q. Prior to the First Boston Corporation presentation did you have any contact with anybody from Basic? Again this [276] is subsequent to the November 27, 1978 meeting and prior to the First Boston Corporation presentation. A. I don't recall that, whether they did or didn't.

Q. You didn't meet them in person, though, did you? A. I'm fairly sure not. * * * *

[277] * * * * Q. Did you have any meetings with anybody at Combustion Engineering during the time period concerning the possible tender offer for Basic? A. Before the First Boston meeting, before the presentation?

Q. Between November 27, 1978 and prior to the presentation by First Boston? A. I don't think so.

Q. Were you having any contact during this period with First Boston Corporation? A. I don't believe so. * * * *

[282] * * * * Q. And I'm wondering if you were aware of why First [283] Boston after developing the first figures then developed these new higher figures. A. I think why they—I don't know specifically, but I do have a recollection that they came back on the 13th and said in the atmosphere of the market you can afford to pay a higher price, and the strategy ought to be to deal with the higher price rather than go in with an offer that they would counter with and you counter again, and the negotiations would go on for a long time. I think the

strategy, the recommended strategy to us when we finally came in on the 13th was let's go with one of these high numbers as a take-out type thing. * * * *

[296] Q. Now, Mr. Kelly, in addition to the strategy of putting forward the best price at the beginning to Basic, did you have any other discussion with First Boston Corporation—again now, I'm talking about discussions rather than the documents which we have—involving what Combustion Engineering's strategy should be in affecting take-over of Basic? * * * *

THE WITNESS: To my recollection they never offered anything that was useful that I can recall other than what I've talked about here.

BY MR. WACHTERMAN:

Q. Did they offer anything which was not useful? A. I don't think they offered anything until probably the 13th of December. The first team never got onto this thing. * * * *

[302] * * * * Q. Mr. Kelly, I tender to you what has been marked as Kelly Exhibit No. 30 and ask you to describe this document, please? A. The minutes of the meeting of the executive committee of Combustion Engineering, Inc., December 14, 1978.

Q. What was the purpose of this meeting? A. The purpose of this meeting was to discuss the possible acquisition of Basic, Inc.?

Q. Was there any other purpose you recall in this meeting? A. No.

Q. Who requested this meeting? A. Mr. Santry.

Q. What transpired at this meeting? A. First Boston presented its report dated December 14, 1978 and made a presentation with the report and made its recommendations on what Combustion ought to do.

[303] Q. And what was that recommendation? A. That we ought to make our best offer and in the range of 45 dollars a share or so would be what they recommended we ought to do, as I recall. * * * *

[304] * * * * Q. Mr. Kelly, what was said to you during that meeting which led you to characterize, as you did in the third paragraph, Basic might be receptive to receiving an acquisition offer? A. The fact that they were considering having the investment bankers meet and see whether a price could be agreed upon by investment bankers.

Q. Do you know whether the investment bankers had ever met prior to December 14, 1978? A. At First Boston and Kidder Peabody on this?

Q. On this. A. I don't believe so.

Q. Do you know why, considering the action planned at the 11-27-78 meeting? A. We never authorized First Boston to meet on our behalf.

Q. Did Basic ever ask you to so authorize them? A. No. * * * *

[321] * * * * Q. The contact with Basic at that time, how did that occur? A. I called Max on the telephone.

Q. What time was that? A. I think it was before the end of the workday, because I think I got him in the office, so it must have been 4:00 to 5:00.

Q. Whose office did you call him from? A. One of the offices down there.

Q. Were you alone when you did that, or was someone else present? A. I was alone.

Q. What was said during that conversation with Mr. Muller? A. I told him that our executive committee had met today and authorized Mr. Santry to make a tender offer for Basic.

Q. And again, that was in the late afternoon or evening of December 14, 1978? A. That's my recollection.

[322] Q. Did you tell Mr. Muller anything else? A. I said I'd like to set up a meeting on the next day which was Friday at his office, to come in and talk to him about the matter with Mr. Santry.

Q. Did you tell Mr. Muller anything else during that telephone conversation? A. Not that I can recall.

Q. Did Mr. Muller ask any questions? A. He was shocked.

Q. Did he ask any questions? A. I can't recall asking questions, but he thought that this action was not—

MR. STERNMAN: He said he thought something? I don't think you know what he thought unless he said it.

THE WITNESS: He indicated that he was not in favor of this approach.

BY MR. WACHTERMAN:

Q. What do you mean by "this approach"? A. Getting together and having Mr. Santry make an offer to him. He thought that our action program was for the bankers to get together and over some extended period of time work out an acceptable price.

Q. Did he therefore not agree to a meeting between you and Mr. Santry? A. He did not agree. He would not meet.

[323] Q. Were there any ultimate arrangements made? A. No. I think that he left his home number and I think there was an arrangement I should call him back later to see whether, what the reaction of the rest of his people was to what I had told him.

Q. And did you do that? A. Yes.

Q. Is that your next contact with anybody from Basic? A. Yes.

Q. What time was that? A. Later in the evening. I don't know exactly when.

Q. Before 9:00 p.m.? A. Yes, before 9:00.

Q. After the workday? A. Yes. And I think I called him and got him at home.

Q. What did you say to him during that conversation? A. I asked him—I believe I asked him whether he would meet with us, and his answer was no.

Q. You asked him again for the same kind of meeting with you and Mr. Santry? A. Yes.

Q. And again he said no? A. Right. * * * *

[325] Q. During either of these two telephone conversations with Mr. Muller did you mention any price to him? A. No.

Q. Did you mention whether Combustion Engineering was interested in a cash tender offer at this time? A. I don't recall.

Q. Did Mr. Muller ask you any questions about what price Combustion Engineering was going to offer? A. I don't think so. * * * *

[326] * * * *

Q. Do you recall anything else you said to Mr. Muller during that conversation? A. I don't recall now. But I think we had arrangements to talk later on in the day, and I believe during that conversation he told me that someone from Kidder Peabody was coming in that afternoon to meet with him.

Q. Did Mr. Muller say anything else during that conversation? A. Not that I recall.

Q. What, if anything, did he say in response to your question about the activity in the stock, stock in Basic, Inc.? A. I don't know whether he was aware of it at the time. He had apparently left the office and gone to some sort of a Thanksgiving or Christmas lunch. He may not have known about what was going on till I told him.

Q. Did you ask him whether he knew if anyone outside of himself knew about the proposed Combustion Engineering tender? A. I don't recall.

Q. Prior to your telephone call to Mr. Muller on December 15 what were you doing during that day? Were you having any meetings with anybody, any conversation with anybody else about Basic? A. I don't recall that. I was watching the stock quote, though, and saw the unusual activity. That's what caused me to [327] call him.

Q. When was your next contact with anyone from Basic? A. I really don't know. I may have talked to him later on in the day. He did call me at home over the weekend. * * * *

[328] * * * * Q. I think you mentioned another conversation with Mr. Muller on the evening of December 15th, a conversation. A. Afternoon, subsequent to my morning conversation with him either on Friday afternoon or Friday

evening or Saturday morning. He agreed to meet with Mr. Santry and me on Tuesday. And I believe in one of these conversations he told me they were going to request trading in the stock be suspended on Monday.

Q. Did he say why they were going to do that? A. Because of the meeting that we had set up for Tuesday. * * * *

**Excerpts from the deposition of Mathew J. Ludwig
by Respondents**

[38] * * * * Q. You say you telephoned Mr. Muller?
A. Yes.

Q. What did you tell Mr. Muller? A. I told him the Exchange had called and suggested that it would be appropriate to issue a release.

Q. Did you tell him that the Exchange had made an inquiry about the trading activity in Basic stock? A. Yes.

Q. What did you tell him about that inquiry? A. I don't recall exactly, just that they had made one and, on learning from us that we had no knowledge of what caused this, suggested a release. * * * *

[40] * * * * Q. During the telephone conversation with Mr. Muller was there any mention or discussion of the discussions that had taken [41] place between Basic and Combustion? A. Not that I recall.

Q. Was there any discussion of those discussions between Basic and Combustion during the entire time of the meeting that took place in Mr. Steinbrink's office? A. I recall none. * * * *

[122] * * * * Q. You indicated before that there were some discussions between Basic and Flintkote.

Did those discussions continue beyond the period of this article? A. They were in this general time zone. I don't recall the exact date, but three Flintkote people came to visit us on

the possibility of our joining forces in building a facility at our Fredonia, Ohio high calcium limestone property to make lime.

The reason we turned to Flintkote was because they, of course, have a number of lime operations around the country, and I think the discussions on that project did continue for some time after, but I don't [123] think—

Q. Did any discussions between Basic and Flintkote continue into 1978? * * * * A. I don't believe so. * * * *

[139] * * * * Q. What officers or employees of Combustion did you meet with at that time, that is, at the time of your first meetings or discussions with officers or employees of Combustion? A. The first time I have any recollection of ever meeting with anyone from Combustion was in that area of 10 to 15 years ago, and the persons were Messrs. Kelly and I don't know whether it was the present Santry or his uncle. * * * *

[202] Do you recall whether Mr. Thomas was receiving calls from shareholders and brokers in 1976 and 1977 asking about the causes of trading activity in Basic stock? A. I don't know that I could answer for Mr. Thomas.

Q. I'm asking you whether you were aware that Mr. Thomas was receiving such calls?

THE WITNESS: May I have the question again?

MR. ELKIND: Let me rephrase the question. I'll make it clearer, if it wasn't clear already.

Q. In 1976 or 1977 were you aware that Mr. Thomas was receiving calls from brokers and shareholders inquiring into the causes of the trading activity in Basic stock? A. Yes, I was aware that Mr. Thomas was receiving calls from brokers and shareholders. I don't know to what extent they were directed as to the reason for the activity in the stock.

Q. Well, do you recall that there were some calls from people who were asking about the reasons for the trading activity in Basic [203] stock? A. Well, I know I had a few, and I believe Thomas had more than I did, and I don't know who else might have had similar calls.

Q. Was Mr. Thomas put in charge of fielding those calls, receiving them and responding to them?

MR. MADSEN: What time are you referring to?

MR. ELKIND: 1976 or 1977.

A. I don't think there is any official directive saying you, Thomas, are in charge of fielding all these calls, but I know I got some, Thomas got some, and I think he probably got more than I did, and I believe Muller also got some. I think Jeff Collins may have gotten some too.

MR. MADSEN: Do you know whether Mr. Collins got any?

THE WITNESS: I don't know that Mr. Collins got any.

Q. Were there discussions between you and any other officers or personnel of Basic as to how you should respond to inquiries about the causes of trading activity in Basic stock [204] in 1976 or 1977? A. I'm trying to recall whether there were. I can't say for certain whether there were or were not.

Q. Well, did you develop some common response that you would all make in response to inquiries about the causes of trading activity in Basic stock?

MR. MADSEN: Object to the form of the question.

A. I don't seem to be able to recall any such, say for instance, Muller, Thomas and I getting together and saying here is the outline.

Q. Was it up to the discretion of each individual what to say in response to the inquiry from the shareholder or broker?

MR. MADSEN: Object to the form of the question.

A. I'm trying to recall whether there were any meetings between the three of us to do that. I don't remember.

Q. You're limiting the question more than what I'm intending.

My question is not whether you had a [205] meeting and sat down and agreed that this was what your response would be.

My question is whether there was an understanding as to what the response would be? * * * * A. I cannot come up with my understanding between the three officers, because Muller certainly didn't need my understanding. I mean by that to say, he could do what he—

[206] * * * * Q. Did you have calls from brokers or shareholders in 1976 or 1977 asking you about whether or not you knew the reasons for the trading activity in Basic stock? A. I don't have any recollection about 1976, and as for whether there were any on that point in 1977, I'm not having any success in trying to recall any calls that asked that specifically.

Q. I'm not asking you specifically to recall [207] one specific call. I'm asking you, generally, whether you recall receiving such calls in 1976 or 1977? A. I can't recall whether I had any is my point. I have little doubt I had some, but I can't recall.

Q. Can you recall what you responded to such inquiries? A. Well, I can't recall what I responded, excepting perhaps very general terms, such as we know of no reason for the activity for the most part, and I can't pinpoint the period.

I think throughout this entire period of 1976, 1977 which you have referenced, that that was the center of my response, lest it be later in 1977, at which point there were rumors of various and sundry tenders offers believed to be in the process, and at that point, if I was aware that there were rumors, I think I would have—

MR. MADSEN: Are you recalling what you did now or are you speculating?

THE WITNESS: No. When say I think, I think I'm recalling that I would have said there were rumors.

[208] Q. Did you receive calls from people who told you they had heard rumors that company X was preparing to make a tender offer for Basic? A. I don't recall that any shareholders ever made that point.

Q. Brokers? A. I don't believe I recall that any brokers did.

Q. From what sources did such rumors come? A. Oh, for example, from talks with our specialist.

Q. Who was your specialist? A. The fellow who was our specialist for the longest period was Jimmy Gallagher. He passed away, I can't recall precisely when.

Q. Who followed Mr. Gallagher as the specialist?

You're referring to the specialist on the floor of the Exchange? A. Yes.

Q. Who followed Mr. Gallagher as your specialist?

A. Let's see. It's a long name, but they've gone from my mind. Oh, the Rosenau firm. I [209] don't remember what the rest of the name is.

Q. Do you recall any particular conversations with the specialist in 1976, 1977 or 1978?

MR. MADSEN: On what subject?

A. Not as to timing.

Q. On the question of whether there was any validity to rumors of possible merger activity?

MR. MADSEN: Object to the form of the question.

A. Let me say this. Gallagher would call me periodically if in his view there was some unusual activity, and on one of the last conversations I had with him, or it could be the principal who followed him, of a rumor of an offer of X dollars, I don't remember what the X was, but I said, well, who is the rumored offerer, and whichever of the two guys it was who had said that, it was said it doesn't have to be anybody, we just have rumors.

Q. Well, did he identify a company? A. No.

[210] Q. Did he tell you that he had heard a rumor but didn't know what company it was that was preparing to make the tender offer? A. Well, yes, it was rumored that there would be a tender offer, and they had no company to tie it to.

Q. They had no company to tie it to? A. Right.

Q. Do you recall when this conversation took place? A. No, I don't, but I'd be pretty certain it was not in 1976, but might have been later in 1977.

Q. Were there any such conversations in 1978? A. Not with Gallagher, because I'm sure he had passed on by 1978, and then it was this other fellow. I can't put a time on these rumors, but at one point there were a number of Cleveland companies, for example, who were rumored as going to make a tender offer.

Q. By whom were these Cleveland companies identified? A. By whom?

Q. By whom. A. I don't remember. But I remember that [211] Ferro Corporation was one of them, and Max Muller knew the Max Muller of Ferro and call him up and said, hey, I hear you're making an offer and why don't you come in the front door instead of starting rumors?

The guy says, I don't know anything about it.

Q. Well, what was your response when you received telephone calls from the specialist stating that he had heard rumors of a possible tender offer for Basic? A. Well, if he could give me a name. People that we knew—

Q. What if he couldn't give you a name? A. That's what happened at the tail end is what I'm talking about. He says, who needs a name, they're just rumors.

Q. Did you ever tell him that you had information that a company was preparing for a tender offer for Basic? A. Did I ever tell him?

Q. Did you ever tell him that? A. No. I never had one.
• • • •

[236] Q. "AMC okay 6/16/77. MJL okay 6/17/77 MM okay 6/16/77"? A. Yes.

Q. Have you seen that document before? A. I don't recall seeing it before.

Q. Do you recall Mr. Muller or anybody else at Basic asking you whether you would be available for a meeting with Mr. Kelly on June 24, 1977? A. I do not recall, though this, of course, says such a call was made.

Q. Do you recall being advised that there was going to be another meeting with Mr. Kelly in mid 1977? A. No, I do not recall it.

Q. Do you recall meeting with Mr. Kelly again in June 1977? A. No.

Q. Let me show you a document that has previously been introduced as Plaintiff's Exhibit 50, and I ask you if you can identify the document? A. It is identified as Plaintiff's Exhibit 50 Muller, and it has 1977 written on it, and the lower part of the document bears the date [237] of June 24th, which is Friday, and in the left margin there is a bracket from approximately 3:00 to 5:00 indicating a meeting involving Muller, Caito, Kelly, and since it's in my writing, of course, I was there too.

Q. This is from your personal diary, is that correct? A. I believe it to be, yes.

Q. Is it your handwriting? A. Yes.

Q. Now, does this indicate two separate meetings? A. See, there's a little scribble there. It looks to me like this first meeting terminated at, I don't know, quarter to 5:00 or 4:30.

Q. That is the meeting with Mr. Muller, Mr. Caito, Mr. Kelly and yourself? A. Right. The second wiggle here, aftermath of above with Muller and Caito.

Q. That is a separate meeting between yourself, Mr. Muller and Mr. Caito concerning the aftermath of the above meeting with Mr. Kelly? [238] A. Right.

Q. Does this document indicate how long the the meeting between yourself, Mr. Muller, Mr. Caito and Mr. Kelly lasted? A. Only in that the second meeting starts—see that little mark there (indicating)?

Q. Yes. You're referring to the mark on the left-hand side? A. Yes. That appears to be about, oh, a little less than half of the space between 4:00 and 5:00, 4:00 being 4:00 o'clock and 5:00 being 5:00 o'clock.

Q. Based upon the document, how long do you believe the meeting between Mr. Muller, Mr. Caito, yourself and Mr. Kelly

lasted? A. I would say somewhere between an hour and a half and maybe ten minutes more.

Q. What was the purpose of that meeting? A. I do not recall.

Q. Do you recall what was discussed at the meeting? A. No.

Q. Do you recall why Mr. Caito was there? A. No, I do not recall why he was there.

Q. Do you recall whether documents were [239] exchanged at the meeting? A. No. I do not recall.

Q. Was there a discussion about the possibility of Combustion acquiring Basic? A. I don't know.

Q. Was there a discussion about the price which Basic might want for its stock or the price which Combustion might be willing to pay?

MR. MADSEN: Object to the form of the question.

A. Not to my recollection.

Q. Do you recall what Mr. Kelly had to say at the meeting? A. I do not.

Q. Anything about what he had to say? A. No.

Q. Do you recall anything about what Mr. Caito had to say? A. No.

Q. Anything about what Mr. Muller had to say? A. No.

Q. Do you recall whether you said anything at the meeting? A. No.

[240] Q. Well, let's go down to the next meeting below that, which says, "Aftermath of above with MM and AMC."

Do you recall how long that meeting lasted? A. Well, it looks like somewhere between 15 and 20 minutes.

Q. Do you recall what was discussed then? A. No.

Q. Do you recall why you had a separate meeting with Mr. Muller and Mr. Caito after Mr. Kelly left? A. I do not recall specifically, no.

Q. You don't recall what was discussed? A. No.

Q. You don't recall what anybody said at the meeting? A. No. Well, the only clue is that it says, "Aftermath of

above." Now, what was discussed, I don't know. I would have to say it was whatever was discussed in the one that included Kelly. I have no recollection of what was discussed at either of the meetings. * * * *

[267] * * * * mark it as—

MR. ELKIND: 96A, yes.

MR. MADSEN: Thank you.

BY MR. ELKIND:

Q. Does this refresh your recollection as to whether you met with Mr. Caito, Mr. Muller and Mr. Kelly on or about October 12, 1977? A. It says I did, but I do not recollect it. I don't recollect what it was all about.

Q. Do you recall when the October 12 meeting was set up? A. No.

Q. Do you recall who set it up? A. No.

Q. How did you learn that there was going to be a meeting on October 12? A. No doubt I was told by Muller.

Q. Did you say by Muller? A. That would be my guess.

MR. MADSEN: I don't want you to speculate. Do you know how you became aware that there was to be a meeting that day?

THE WITNESS: No.

Q. The diary indicates that October 12 was Columbus Day, traditional Columbus Day. [268] Do you recall meeting on traditional Columbus Day? A. No, not per se.

Q. Do you recall where you met?

MR. MADSEN: We have no objection to the witness looking at his original diary to see if it will assist him in determining where the meeting was held if our doing so is not argued to be some sort of a waiver.

MR. ELKIND: So agreed.

A. I can say this was held in our office.

Q. Do you recall what the purpose of the meeting was?

A. No, sir.

Q. Do you recall what was discussed at the meeting? A. No.

Q. Anything of what was discussed? A. No.

Q. Do you recall even the subject matter of the meeting? A. No.

Q. Do you recall whether there was discussion about Combustion acquiring Basic? [269] A. I do not recall it.

Q. Do you recall anything that Mr. Muller said at the meeting? A. No.

Q. Anything that Mr. Caito said at the meeting? A. No.

Q. Anything that Mr. Kelly said at the meeting? A. No.

Q. Anything that you said at the meeting? A. No.

Q. Do you know whether there are any memoranda of the meeting? A. No, I do not know if there are any memoranda.

Q. Do you know what the results of the meeting were? A. No.

Q. Do you know whether it was agreed that there would be a subsequent meeting to follow up on this meeting? A. No.

MR. ELKIND: I'd like the reporter to mark as Plaintiff's Exhibit 97 [270] what appears to be an entry from Mr. Ludwig's diary for the date Thursday, October 20, 1977. It's a redacted version of his diary for that date and the document that's going to be marked has been produced as B-1981-8 i

(Ludwig Deposition Exhibit 97 was mark'd for purposes of identification.)

BY MR. ELKIND:

Q. My first question is going to be that I can't read the handwriting in the diary for Thursday, October 20.

Mr. Ludwig, this your diary for Thursday, October 20, 1977, your personal diary?

MR. MADSEN: Off the record

(Discussion had off the record.)

Q. Mr. Ludwig, can you identify Plaintiff's Exhibit 97?

A. Yes. It has 1977 handwritten on the top, Thursday, October 20th. I recognize it as coming from my diary because that sure looks like my handwriting.

[271] Q. Can you read that handwriting at the bottom of the diary for Thursday, October 20?

I will tell you this is the way the document was produced to us. It appears to be a redacted version of your diary. A. Yes.

Q. Can you read the handwriting, the single line of handwriting that's been left for Thursday, October 20? * * * *

* * * * A. The writing beneath the 5:00 is 5:40, I think. "MM re telephone with Jack Bryan."

Q. Could you identify Mr. Jack Bryan for the record, please? A. Jack Bryan was a reporter for the Cleveland Plain Dealer at one time. * * * *

[279] Q. Do you recall talking with anybody, at or about the time that this article appeared, about the appropriateness of issuing a public statement that "no negotiations were under way with any company for a merger"?

MS. BLAKELEY: Other than counsel.

A. I believe not.

Q. Mr. Ludwig, when was the first time you talked with somebody at Basic about the advisability of retaining an investment banker? A. I think late in 1977.

Q. Can you fix a date a little bit more precisely for me; October 1977? A. I could be more specific by using a date that does come to my mind—

Q. Why don't you do that? A. —which I'll preface only with a limited generality.

We had become concerned about all the unsolicited tender offers that were going on around the countryside, and our interest was primarily in the direction of finding someone who would help us in the event we had [280] unsolicited tender offers through a national publication, which might have been Business Week or one of that type of magazines, which reported on Kidder Peabody's Martin Siegal and I think

Goldman Sachs' Freedman, and I don't know who the other was from one other prominent investment banking house.

Ted Thomas and I met Siegal along with a couple of his associates in New York to get better acquainted and see whether he might not be the kind of fellow that we'd like to have on our team in the event that we had some, unsolicited, undesirable, whatever, approaches.

Now, that visit to Siegal and several other people we met was early in November of 1977 and— * * * *

[289] * * * * Q. Was Kidder Peabody asked to prepare an evaluation of Basic or Basic's stock?

MR. MADSEN: At what point in time?

MR. ELKIND: At the time of this retainer dated February 9, 1978.

A. No.

Q. Did there come a point in time when they were asked to prepare a valuation of Basic and Basic's stock? A. I don't recall exactly when, but much later in 1976.

[290] * * * * Q. At the time the Kidder Peabody contract was renewed in May 1978, did you talk with Kidder Peabody about preparing a valuation of Basic's stock or Basic? A. I believe not. * * * *

[342] * * * * Q. Plaintiff's Exhibit 73 is dated February 9, 1978 but refers to Kidder Peabody's initial employment for the six month period commencing November 16, 1977.

When was Kidder Peabody actually retained? A. I don't recall the exact date, but it was not very many days after the session in New York on the 9th, November 9th.

Q. Were they retained orally before there was a written retainer that was prepared? A. Yes. I just called Siegal, as I remember, and said welcome aboard or whatever you say in situations like that.

Q. When you called him, did you talk with him about the services that he would be performing? A. I knew what services they'd be performing.

Q. What did you tell him about the services that he would be performing? A. What we talked about in New York.

Q. Let me ask you this question.

You said that a team came out for the first time to Basic several weeks after the initial retainer? [343] A. Yes.

Q. Was that several weeks after the retainer in November of 1977? A. Yes.

Q. That was the team of three people that came from New York to Cleveland? A. I've forgotten how many there were at that particular time, but the visits were periodic and there were telephone conversations.

I don't recall what time this was, but just to illustrate, when there was a fair amount of volume one day, I recall telephoning Siegal and asking him to take a look into it and see whether he thought that was anything we ought to be concerned about, and he reported back that he had and there was no reason to be concerned. In other words, there wasn't any concentrated buying or whatever.

Q. Well, let's get back to the evaluation that was being done of Basic by Kidder Peabody.

They sent three people out several weeks after the initial retainer? [344] A. When you say evaluation, I don't know if I'm sure that I understand. What these people were doing was getting to know Basic, visited plants, learned about the industry and the customers we were serving.

I don't want to appear to be trying to make anything out of it that is any different. It was the examination of all these important factors of the operation and the markets and the profits and what have you.

Q. How many trips did Kidder Peabody make out to Cleveland to, as you describe, get to know Basic? A. I don't recall how many they made, but there were, I'd say, a minimum of three.

Q. Do you recall approximately when those trips took place? A. I think I remember the first one better, because I don't think I participated in all of them. But I think at the very latest it was January of 1978. It may have been December of 1977.

Q. That was the first trip? A. Yes.

Q. When were the next two trips? [345] A. I don't recall.

Q. Can you tell me approximately when they were? A. No, I don't think I can recall dates, but I would guess probably February, or March anyhow, when the figures for 1977 were available, full figures.

Q. When did your fiscal year end at Basic? A. December 31st.

Q. And you do recall that when the figures became available there was a second trip by people from Kidder Peabody out to Basic? A. I don't actually recall. All I'm saying is that would have been a logical time.

Q. Do you recall when the third trip took place, without specifying the date, the approximate time, the season or the month, if you can recall that? A. No. I probably shouldn't have been speculating on February or March.

MR. MADSEN: I don't want you to speculate with respect to any answer, Mr. Ludwig. If you know what the facts are, please testify.

A. I do not recall.

[348] * * * * Q. Did you talk with Kidder Peabody about the possibility of a friendly offer at the time that they were retained in November of 1977? A. No, not that I recall.

Q. When is the first time somebody talked with Kidder Peabody about the possibility of a friendly tender offer? A. Oh, I think about December of 1978.

Q. When did Kidder Peabody begin preparing its evaluation of Basic? A. Which evaluation?

Q. You said that they had been working on an evaluation of Basic. A. I don't recall that.

[349] Do you mean the one they made in connection with the December 19th offer?

Q. Yes. A. Well, quite separate and apart from the other things, that is, the defense mechanism, whatever you call it, that evaluation was put together in about three or four days. * * * *

[366] * * * * Q. Was it your understanding at the time of Kidder Peabody's retainer that Kidder Peabody was to familiarize themselves with the company and to be prepared to issue a report of some kind? A. I don't believe we particularly were pointing towards a report. We just wanted them to be as fully informed as they thought they ought to be should they be called upon [367] to protect us.

Q. Well, did you want them to be as fully informed as they could be so that they would be in a position to render an opinion as to the value of the company? A. I don't think so, necessarily. Our primary concern was to have somebody looking after Basic in the event an undesirable or unsolicited offer, whatever, was made to us.

Q. Well, what if a friendly offer was made to you; were you contemplating that Kidder Peabody would be in a position to evaluate the fairness of that offer? A. I don't believe we considered that at the time, that is, a friendly tender offer, but certainly not when we entered into this agreement, and I don't think at any renewal date either. * * * *

[373] * * * * Q. I'm asking if that's what it purports to represent in the document? A. I don't know what inventories. I don't recall the inventories or what have you.

Q. Can you tell me why you prepared these figures for Combustion Engineering and Basic Incorporated that are reflected on the top four lines of the exhibit? A. I don't recall why.

Q. Were you comparing certain financial information of Combustion with certain financial information of Basic? A. I'm sorry. Is that a question?

Q. Were you comparing financial information of Combustion with financial information of Basic? A. Limited financial information, yes. * * * *

[379] * * * * Q. Let's look at the line that says BI, referring to Basic, and then it seems to have an at sign, then CE LIFO and 7.4 percent in parentheses.

Do you see that? A. Yes.

Q. Can you tell me what that means and what it refers to? A. Well, that means, if I had applied to Basic's \$18,000,000 odd of inventory the same percentage that was in the Combustion figures of 7.4, the Basic's provision, instead of being 4,259,000, would have been 1,389,000.

Q. Can you tell me why you were taking the percentage of LIFO reserves used by Combustion and applying that percentage to the total inventories of Basic? A. Why I did it?

Q. Why you did it. A. Well, as the statement goes on to show, the effect of one set of numbers versus the other on the average per share.

Q. Well, can you tell me why you were trying [380] to take the percentage of LIFO reserves that Combustion used in preparing its financial statements or tax returns and apply that same percentage to Basic to recompute what Basic's earnings would have been? A. Well, as I think I've said a couple of times, it shows the effect on the average earnings per share.

Q. Why were you trying to show the effect on the average earnings per share of Basic by taking the percentage of LIFO reserves used by Combustion? A. From one piece of paper, I can't tell. I don't know why I was doing it. I can tell you what the figures are and, within limits, I can tell you the effect on the income per share.

Q. Were you trying to find the effect on Basic's earnings per share of using certain accounting procedures that were used by Combustion in preparing its own financial statements? A. Well, that's what it appears to be from here, yes.

Q. Now, let's go on to the next page.

[381] Are you absolutely certain that the writing that appears on the top half of page two of this exhibit is not your handwriting? A. That's what I said before.

Q. Well, what I'm trying to determine now is your degree of certainty.

Are you absolutely certain that that is not your handwriting?

MR. STERNMAN: Can you tell me what you mean by absolutely certain?

MR. ELKIND: What I'm trying to find out is whether the witness thinks it's not his handwriting but has some doubt about it or whether he is absolutely certain that this is not his handwriting.

A. Down through this point, tender offer \$23, is absolutely, positively not my handwriting.

Q. Do you know whose handwriting that is? A. I'm not certain, but I believe it's Thomas'.

Q. Do you recall whether the two pages of what has been marked as Plaintiff's Exhibit 90 are part of the same document? A. I don't believe so.

Q. You don't believe so? [382] A. No.

Q. What is the basis for your belief that they are not part of the same document? A. Well, because one is a determination of the effect of LIFO reserve on inventories and the other is market values of earnings per share of an entirely different company.

Q. Well, when you say an entirely different company, what entirely different company is it that you say the document refers to? A. Well, I think that says Vetco on top.

Are we on the second page?

Q. Right. A. Yes.

Q. Is Vetco a corporation? A. I don't know if it still is or not, but I think it was one that was acquired by CE. Whether it's still a separate corporation, I don't know.

Q. Do you know when Vetco was acquired by CE? A. No.

Q. Do you know why Mr. Thomas would have prepared a document reflecting figures for Vetco? A. I don't think I have any recollection of * * * *

[404] Q. Isn't it a fact, Mr. Ludwig, that the purpose of making that calculation was to determine the effect of a combination between Basic and Combustion upon Basic's financial statements? A. I don't think that follows at all.

Q. I'm asking you, was that one of the purposes of this calculation? A. I told you before that I didn't know what the purpose was beyond what the arithmetic result was.

Q. You don't know why you did the arithmetic calculations? A. No. * * * *

Q. Mr. Ludwig, I show you Plaintiff's [405] Exhibit 20C, which Mr. Muller has testified is a document that he prepared and which he referred to as his memory crutch, and I ask you whether you ever saw the entry toward the bottom of the page beside November 10, 1977 that says, "Kelly asked, are you ready to merge with Basic"? A. If I ever saw that?

Q. Yes.

MR. MADSEN: He's asking you if you ever saw this document.

A. And particularly that, or this document period?

Q. I will tell you that Mr. Muller has testified that that is part of a memory crutch that he prepared which consists of a number of pages.

The document has been produced to us in various forms, occasionally one or two pages at a time with substantial redactions, but a review of Plaintiff's Exhibit 20 may assist you in responding to the question. A. I'm not certain I've ever seen this.

This is a full sheet, I take it, with only this redacted (indicating)? * * * *

[431] * * * * Q. Were you also aware at the time of this meeting of Combustion's interest in acquiring the areas of refractories ability that Basic had? A. I don't recall being particularly aware of such a situation, but if that did exist, and I don't know if it did, the fact that he was willing to listen was what we were interested in and the reason for this meeting.

Q. Isn't it a fact that Mr. Kelly had told you that Combustion was very interested in moving into the area of the refractories business that Basic was in and that the only way that Combustion could do that was by acquiring Basic? A. I never heard that.

Q. You don't recall hearing that as early as your January 12, 1977 meeting with Mr. Kelly? [432] A. I do not.

Q. Do you recall Mr. Kelly talking about Combustion's interest in expanding its product lines and capabilities at the February 27, 1978 meeting at Burke Airport? A. I do not.

Q. When did the idea of acquiring Combustion's refractories division first occur to somebody at Basic? A. I don't recall. I don't recall who had the idea, as I stated before.

Q. You testified that Basic did not have the cash to make a cash acquisition of Combustion's refractories division?

MR. MADSEN: I don't believe that's what he testified.

A. No, I didn't. I said, in effect, I thought the probability would be that we would not have enough money to acquire Combustion's refractory division as being the reason we volunteered our Basic numbers.

Q. Did you talk about the price which Combustion would want for purchase of its refractories division at the February 27 meeting? [433] A. No.

Q. When is the first time you talked about the price which Combustion would want for its refractories division? A. I believe in June.

Q. Of 1978? A. Yes.

Q. What price was stated? A. We offered \$26,000,000.

Q. And what did Mr. Kelly say to that? A. In a word, he wasn't interested at that figure.

Q. Did he tell you that he was interested at the time in Combustion acquiring Basic? A. As I recall, at this June meeting, he did state that he would like to come up with some idea on such a possibility.

Q. Did he say that it would take him some time to come up with an idea on such a possibility? A. I don't recall that he mentioned any time problem.

Q. Did he say what he would like to do to come up with such an idea? A. I don't recall, other than the substance [434] of his thought of coming up with some kind of a plan.

Q. When you say some kind of a plan, you're referring to some kind of a plan for Combustion to acquire Basic, is that right? A. Yes.

Q. Let's get back to the February 27, 1978 meeting.

Can you tell me, by reviewing Plaintiff's Exhibit 60, how long that meeting lasted? A. The airport meeting?

Q. Yes. A. Oh, it looks like about—

MR. MADSEN: You're asking the duration of the meeting itself rather than time involved in getting to and from the meeting?

MR. ELKIND: Yes.

A. It looks like something of the order of an hour and a half or so.

Q. That's the meeting at the Burke Airport? A. Yes.

Q. After the meeting at the Burke Airport you had a meeting with Mr. Muller and Mr. Caito regarding the above, it says; that's [435] what is says on the diary, is that right? A. Yes.

Q. How long did that meeting last? A. Oh, that looks like about the same time as the first one, like an hour and a half. That includes time of getting back to the office, I'm sure. I didn't spell out the travel time.

Q. Prior to the meeting with Mr. Kelly at Burke Airport, did Mr. Muller tell you the purpose of the meeting? A. I would reckon he had to tell me.

Q. Well, how did you know that the purpose of the meeting was to talk about the refractories divisions? A. How did I know or how did he know?

Q. How did you know? A. I think that sometime earlier in the month the idea of trying to acquire CE's refractory division emerged in our own office, and I would expect that the participants would have been Caito, Muller and I.

I said before and I say again, I don't know whose idea it was, and I think the meeting with Kelly on the 27th of February, [436] 1978 was as a consequence of Muller calling Kelly saying, hey, when are you going to be here again, remembering that Combustion has a lot of operations in this area, and the date of the 27th was fixed as one which we could meet him enroute to whatever he was doing at his other operations.

Q. Do you know whether Mr. Kelly returned to Stamford

immediately after the meeting at the Burke Airport? A. I have no idea.

Q. Did you meet him at the Burke Airport upon his arrival in Cleveland? A. Yes.

Q. So he flew into the Burke Airport and you met him there? A. Right.

Q. Was there some reason that you met him at the Burke Airport rather than at your offices or the offices of Combustion in Cleveland? A. I think, and this is a little contrary to what I said before when I said that I thought that Muller arranged this particular date because that was the day in which Kelly was going to be in town for visits to his other [437] operations, but I believe that he probably went on to his other operations, whereas I said before that I have no idea where he went. I don't know where he went, but think he might have gone to some of their other operations in the area.

Q. How much of the hour and a half meeting that occurred at the Burke Airport was devoted to a discussion about acquiring Combustion Engineering's refractories division? A. Oh, I didn't keep track, but I would think a substantial part, if not all of it.

Q. Tell me what was discussed about the subject of Basic acquiring Combustion's refractories division. A. I can't give you any details. I've already given you what I recall of the substance.

Q. Was there a discussion about the possible structure of such a deal? A. No.

Q. Was there a discussion about the advantages of such a deal? A. don't recall that there was.

[438] Q. Was there a discussion about the consideration that might be paid to Combustion for an acquisition of its refractories division? A. No.

Q. Was there a discussion in general about the advantages of combining the two refractories divisions, yours and theirs? A. No. Not that recall, anyhow.

Q. Well, can you tell me with greater specificity what was discussed about the idea of combining the refractories divisions? A. I can't give you any details, Mr. Elkind. I simply

don't recall details. But I've given you the substance, which is, A, we're interested, we, Basic, are interested in acquiring your refractory division, your, Kelly, and if this has any interest to you, we would like to get the information, which I outlined before, on sales, profits, working capital, investment, the kind of data we needed to make an evaluation to determine what price we would offer and by what means we would offer that.

Q. Did you consult with Kidder Peabody about [439] the possibility of acquiring Combustion's refractories division? A. No. We didn't even know whether it was for sale or—yes. I don't know if it was for sale. We didn't know whether or not they would be interested in selling.

Q. But you said your reaction was one of encouragement as the result of what occurred at the meeting? A. Yes, because Mr. Kelly agreed to provide the data we wanted.

Q. Thank you.

Prior to the meeting, had Mr. Muller told you that he communicated with Mr. Kelly about the idea of acquiring Combustion's refractories division? A. I don't recall that he mentioned the purpose of our wanting to see him.

Q. You don't recall that he mentioned the purpose of your wanting to see him to Mr. Kelly? A. Yes. I do not recall whether he did or did not.

Q. Well, do you recall, sitting here today, whether Mr. Kelly was informed prior to the [440] February 27th meeting of the purpose of the meeting? A. I don't recall. I didn't talk with him prior to the February 27th meeting on the subject of the meeting that day.

Q. Tell me as best you can recall what Mr. Kelly's reaction was at the February 27th meeting when you first mentioned the idea of Basic acquiring Combustion's refractories division. A. I don't recall his reaction.

Q. During the course of the meeting did Mr. Kelly mention Combustion's interest in acquiring Basic's stock? A. I don't recall that.

Q. Did he talk about Combustion's interest in acquiring a position in Basic? A. I don't recall that.

Q. Did he talk about the idea of receiving Basic's stock in exchange for the Combustion Engineering refractories division? A. I have no recollection of such.

Q. Did he bring up the subject of Combustion's interest in acquiring Basic?

MR. MADSEN: Object.

[441] A. I've answered that at least once before.

Q. After the meeting at Burke Airport you had a meeting with Mr. Muller and Mr. Caito, which you said lasted about an hour and a half.

Can you tell me what was discussed at that meeting? A. The substance of the meeting earlier with Mr. Kelly and the fact that we were promised the information we desired.

Q. Mr. Caito had not attended the meeting at the Burke Airport? A. He had not, that's right.

Q. Why had he not attended the meeting? A. I have no idea.

Q. Was there a memorandum prepared of the meeting at the Burke Airport? A. I don't recall preparing any myself, and I don't know if Mr. Muller did or not.

Q. Was there a memo prepared of your discussion with Mr. Caito? A. No, not by me.

Q. Do you recall talking with Mr. Caito about the steps that would have to be taken as a follow-up to the meeting of February [442] 27th? A. Yes, because we had to assemble data too.

Q. You had to assemble data too? A. Yes.

Q. What data did you have to assemble? A. At that point, I can't even tell you. In fact, I have a little problem telling you now exactly what we turned over to them.

Q. Did you have to turn over data relating to Basic as a whole? A. That's what we agreed to turn over, yes.

Q. Did you have to turn over profit data? A. We did, yes. We didn't have to. This is part of what we offered to give them.

Q. You offered to give them profit data? A. Yes.

Q. Did you offer to give them profit projections? A. I think we did with respect to two periods. I'm not certain

whether the data was all available at this date, but we did offer to give them, and I'm fairly certain we did, let's see, I think starting with the year 1973 through 1976, actual numbers, and 1977 would have been estimated numbers, [443] because at this date I don't think we had them, but we may have by the time we delivered them.

MR. MADSEN: By this date do you mean February 27, 1978?

THE WITNESS: Yes.

MR. MADSEN: Thank you.

A. And 1978 budget numbers.

Q. Did you also agree to give them profitability projections for 1978 and subsequent years? A. No. 1978 was the last year.

Q. Did you agree to give them profit projections for 1978? A. Budget, yes.

Q. Projections? A. That's what we call a budget.

Q. Were those numbers public information? A. No.

Q. What other financial information did you agree to give them? A. I think we gave them what amounts to cash flow, as to what capital improvements we contemplated, debt requirement for servicing the then senior securities, that sort of [444] thing.

Q. Why was it your belief that Basic would have to make a deferred payment for Combustion's refractories division? A. Because we didn't have the resources otherwise.

Q. Well, did you have an estimate of what the cost of acquiring Combustion's refractories divisions would be? A. We were pretty certain it would not be \$1,000,000.

Q. How much resources did you have? A. I don't recall exactly at that point.

Q. I don't mean exactly, but give me an estimate of what you thought your available resources were and to what extent you thought you'd have to rely upon financing or deferred payment.

MR. STERNMAN: What do you mean by resources; cash?

MR. ELKIND: Cash.

A. Well, cash or credit is what I'm talking about, resources.

Q. What was your own understanding at the time as to the amount of credit that you [445] would need in order to acquire— A. We had no idea how much credit we would need. We knew it was a substantial business.

Q. Did you have an estimate in your own mind as to the—

A. No.

Q. Let me finish the question so that the record is clear.

Did you have an estimate in your own mind as to what the cost of acquiring Combustion's refractories division would be? A. We did not.

Q. You did have an understanding that it would exceed your available cash resources? A. I think I'm the guy who was doing the speculating, and felt reasonably certain that we would have to obtain some dollars and, to us, a fair number of dollars, and I thought Combustion, on a deferred payout, might be a candidate of that.

Q. Did you talk with Mr. Kelly about the possibility of a deferred payout at the February 27th meeting? A. No.

Q. Did you tell him why it was that you were [446] volunteering, as you put it, to provide him with your financial information? A. I don't recall if I did or not, but the fact of the matter is we gave it to them.

Q. The fact of the matter is you gave it to them? A. Yes.

Q. And you're saying you volunteered to give it to them? A. Yes.

Q. I'm asking you whether Mr. Kelly did not, in fact, request that you provide him with financial information concerning Basic? A. I answered that before in terms of I do not have any recollection of his asking for that information.

Q. Did you make some estimate in your own mind as to the possible range of credit that would be needed to acquire Combustion's refractories division?

MR. MADSEN: At what point in time?

MR. ELKIND: On or about February 27, 1978.

A. No.

[447] Q. Well, let me ask you this.

Without specifying a dollar amount, did you have an understanding that credit in the amount of tens of millions of dollars would be required? A. I did not have any specific number in mind, nor any range, but I don't think, in the light of hindsight, that your guess is a bad one, tens of millions.

* * * *

[512] * * * * Q. Mr. Ludwig, have you had a chance to check your original diary over the luncheon break? A. Yes.

Q. And can you tell me what the entry on your diary for March 1, 1978 refers to, and I mean the second entry on the diary for March 1, 1978? A. The one following the MM?

Q. The one following the MM. A. That is "re above."

MR. MADSEN: Briefly, does what was immediately above that have anything to do with the subject matter of this litigation?

THE WITNESS: Nothing whatsoever.

Q. What I'm asking you, it says "MM", and then there is a blank, and "Kelly call"? A. Yes.

Q. Does that entry refer to the fact that [513] you talked with Mr. Muller and also talked with Mr. Kelly, or does it reflect the fact that you talked with Mr. Muller about Mr. Kelly's telephone call? A. I talked with Mr. Muller about the item that is in the diary above, on the line above the MM and Kelly call, which, the part that has been redacted here is "re above."

Q. Did you talk with Mr. Muller about Mr. Kelly's call? A. Yes.

Q. Mr. Kelly didn't call you, did he?

A. Oh, I neglected to look. I'm pretty sure he called Muller, but let me take a look.

He had not called me, that is, Kelly didn't call me.

Q. Mr. Kelly had called Mr. Muller, right? A. Apparently.

Q. And you talked with Mr. Muller about Mr. Kelly's call? A. Yes.

Q. Did Mr. Muller tell you what Mr. Kelly had called about? A. I have little doubt he did.

Q. Do you recall what Mr. Kelly's call to [514] Mr. Muller was about? A. No.

Q. What did Mr. Muller tell you about Mr. Kelly's call? A. I do not recall.

Q. Do you recall what you discussed with Mr. Muller relating to Mr. Kelly's call or relating to Combustion Engineering during the course of your discussion with Mr. Muller on March 1? A. I do not recall, no.

Q. You have no recollection of what was discussed during the course of the hour and a half conversation that's referred to at the bottom of your diary entry for March 1? A. I don't believe that's an hour and a half.

Q. How long did the discussion last? A. From having looked at the diary, the things that are bracketed in this two plus hour period, the only conversation with Muller was re the Kelly call and this other item, which has nothing to do with Combustion or the Kelly call.

MR. MADSEN: I think the question is do you know how long the [515] discussion with Muller was concerning those two items, whether you can tell from the diary.

A. I believe it is chopped off on either side of that bracket by these two lines (indicating).

Do you have two lines on yours?

Q. I see what you're referring to, yes. A. And I believe the conversation with Muller on this whole line that applies to him was that distance (indicating), which, I don't know, could be like 20, 25 minutes, something like that. * * * *

Q. Do you recall anything that was discussed with Mr. Muller during that conversation other than the item that's been redacted? A. No.

Q. Now, take look at your diary entry for Thursday, March 2, 1978.

[516] The top entry that's been left on this redacted version of the diary that was produced to us appears to me to say TT, and then there is a redaction, and then CE, is that right? A. Yes.

Q. Can you tell me what that refers to? A. As is; you mean the TT and the CE?

Q. Yes. A. Well, I think I was talking with him about Combustion.

Q. Well, what were you talking with him about concerning Combustion? A. I can't tell just taking that line alone.

Q. Do you recall talking with Mr. Thomas about Combustion in the beginning of March, 1978? A. By reason of seeing this, I do, yes.

Q. Do you recall discussions with Mr. Thomas about Combustion in or about the period of March of 1978? A. I do recall talking with him in this period by reason of the appearance of his name twice on that March 2nd.

Q. Did you talk with him about the [517] discussions between Basic and Combustion?

THE WITNESS: Off the record, please. Let me chat with you two just a minute about this.

(Recess had.)

THE WITNESS: Can I have the question again?

(Record read.)

A. I do not recall. That is, I have no independent recollection of what I talked with him about in relation to Combustion.

Q. Well, do you have any recollection of talking with him about Combustion during the early part of 1978? A. At any time, you mean?

Q. Yes. A. I have no dates that I can say from recollection on which I talked with him during the first part of 1978. * * * *

[518] * * * * Q. What does the entry on March 2 relate to, Mr. Ludwig? A. I'm speaking of both entries on March 2nd.

Q. The second entry says, "AMC, TT and EPA read profit data for CE," is that right? A. Yes.

Q. Can you tell me what the two entries for March 2 of 1978 in your personal diary relate to? A. I believe they relate to the February meeting that Mr. Muller and I had with Mr. Kelly at Burke, and I think I can be more specific by reason of the help given me from this profit data, that what we were

probably doing was discussing the information that would have to be gathered to fulfill our offer to give Combustion figures on Basic.

Q. What information did you talk about gathering to be provided to Combustion? [519] A. I believe we covered that yesterday, but if you'd like me to repeat it—would you?

Q. Well, I'd like you to tell me what information or what profit data you talked about gathering during this meeting on March 2 for Combustion Engineering? A. That I cannot be any more specific about than I just have been because I do not recall the details.

Q. In any event, you talked with Mr. Caito and Mr. Thomas and Mr. Arnolt about gathering profit data relating to Basic for purposes of providing that data to Combustion, is that right? A. As we had agreed to at the Burke meeting.

Q. Did you assign tasks of collecting that data to Mr. Caito, Mr. Thomas or Mr. Arnolt? A. I'm not sure we did at this point.

MR. MADSEN: I think you've answered the question.

Q. Did you, either on March 2 or some later point in time, agree who would collect what data? A. I believe so. * * * *

[524] Q. What I'm asking you is, can you tell me the form in which you talked about putting the data together?

MR. MADSEN: Object to the form of the question.

A. I think you've got copies, haven't you?

Q. We've got copies of documents. I'm trying to find out what documents they are that refer to the data that you were collecting and putting together. A. Well, if you've got them—

Q. We've got a lot of documents. We've got financial reports for three years. I'm trying to figure out what data it is that you put together for Combustion and what data you provided to Combustion in connection with this diary

entry. A. I'm not going to be able to give you minute details, there's no ifs, ands or buts about that, but let me give you an example.

We gave them income statements, as I indicated yesterday, I think, for the years 1973, 1974, 1975, 1976, actual, and 1977, which may or may not have been actual at the time, because I don't know what figures we [525] gave them, but by the time Insley arrived we certainly had the full year 1977. We gave them 1978 budget.

Q. You mean 1978 projections? A. 1978 budget. We call them budget.

Q. Did they, in fact, include projections of earnings for 1978? A. We're using a term which I think is on the statements that you've got and which we gave them.

Q. I'm asking you, you call the document a budget, but did the document that you provided to Combustion include projections of earnings for the full year of 1978? A. Yes.

Q. You mentioned that you also gave Combustion certain information concerning advertising, you said? A. That's what I said. I don't know what we gave them in that detail. I think we gave them product information.

Q. What do you mean by advertising? A. Well, what we advertise our products with that tell us what the products do and what they are. That's advertising.

[528] his testimony, originally, he said that he was not sure whether Mr. Insley brought this with him or it was prepared by Mr. Insley subsequently, and I believe that the witness' recollection is refreshed that it was prepared by Mr. Insley subsequently and received by Mr. Ludwig from Mr. Kelly on June 7, 1978.

I realize that I have just been testifying, which was not my object, but perhaps you can ask the witness whether my statement is factually correct.

BY MR. ELKIND:

Q. Is the statement of your counsel factually correct? A. Yes.

Q. Does it accurately reflect your recollection of the facts? A. Yes.

Q. Can you tell me whether Plaintiff's Exhibit 44 is one of the documents that was assembled at Basic and provided to Combustion? A. I believe only the top four. * * * *

[535] Q. Was it trading in that range at the time? A. I have no recollection.

Q. On the right-hand side toward the top of the page is the calculation of 1,387,383 and then it appears to be added to 163,109 for a total of 1,550,492? A. Yes.

Q. Do any of those numbers mean anything to you? A. If that is the number of shares (indicating)—

Q. You're pointing to the top number, the 1,387,383? A. Yes. That could be Basic's common shares outstanding.

Q. Did Basic have approximately 163,109 preferred shares outstanding in the early part of 1978? A. I don't think so, but I think those might have been convertible. Remember, those were convertible shares into that many common shares. * * * *

Q. I see. So it's your recollection that the number 163,109 may represent the number of common shares into which convertible [536] shares could be converted.

Q. Is that your recollection? A. That's not my recollection. I don't recall. But what I'm saying is, I don't know what this date is, it's not Basic's document, but I did say that I thought at this time we could have had about that many shares outstanding. This is too exact a figure for me to say is the number on date X, and I don't even know what date X is (indicating).

MR. MADSEN: To what figure have you just been pointing your finger?

THE WITNESS: The 1,387,383 shares.

Q. How many shares of preferred stock did Basic have outstanding in the early part of 1978? A. I do not remember.

Q. Approximately? A. I don't remember.

Q. Can you tell me whether they had more [537] than 100,000 shares of outstanding preferred? A. I can't, no.

Q. On the next page there is more handwriting, and the page is entitled assumptions.

Can you tell me whose handwriting that is? A. It does not look like anyone's at Basic that would be in the accounting end of it, certainly.

MR. ELKIND: I'd like the reporter to mark as Plaintiff's Exhibit 104 a six page document which has been produced to plaintiffs as B-4-12.

(Ludwig Deposition Exhibit 104 was mark'd for purposes of identification.)

BY MR. ELKIND:

Q. Do you recognize Plaintiff's Exhibit 104, Mr. Ludwig? A. Yes.

Q. Can you tell me who prepared the document? A. I believe all of these were either prepared by Arnolt or under his direction.

[538] Q. Do you recall when the document was prepared? A. I do not recall.

Q. Let me point out to you, in the upper right-hand corner it says, "EPA 3/9/78."

Do you see that? A. Yes. I was trying to make out whether that was a 78. That's a funny looking 78.

Q. Does that refresh your recollection as to when the document was prepared? A. Yes, that does.

Q. Is this one of the documents that was prepared for the purpose of providing Combustion with financial information concerning Basic in early 1978? A. I believe so.

Q. Had you talked with Mr. Kelly or anybody else from Combustion about providing information relating to the electronics segment of Basic? A. We talked about providing them the entire story on Basic at the February meeting.

Q. At any time after the February meeting up through June of 1978 did Mr. Kelly talk to you about the information that he would like [539] to receive? A. I don't recall whether I talked with Kelly, I may have, about some of the figures that either we

were providing or they were providing. I believe what we eventually provided at the meeting with Insley reflected whatever we talked about, and I do not recall anything in particular that we talked about.

Q. What I'm asking you is, were there conversations with Mr. Kelly or anybody else from Combustion at which they said to you, we'd like to take a look at this information or that information relating to Basic?

MR. MADSEN: Object to the form of the question.

THE WITNESS: Pardon me?

MR. MADSEN: You may answer. I objected to the form of the question.

A. I don't recall anything specific, and what I did say before, I think I may have talked with him. I know I talked with Insley a number of times, because we had a little problem setting a date, and he might have been calling me about what they were going to [540] provide or about what we were going to provide, but I have no recollection of anything that was outside the area that I felt was appropriate in the light of what we were getting from Combustion.

Q. That's not what I'm asking.

My question is, were there instances in which Mr. Insley, Mr. Kelly or anybody else from Combustion expressed an interest in receiving certain kinds of data— A. Not to my recollection.

Q. —in addition to the data that you had previously talked about providing each other? A. We didn't talk, either one of us, at the February meeting, about detailed requirements or desires. What we asked him for was in broad terms, and what we contemplated giving him, and which I believe we did give, was in the same context.

Q. So, in other words, the information which they agreed to provide to you and which you agreed to provide to them was discussed in broad terms only? A. Right. * * * *

[541] * * * * Q. I show you a document that has just been marked as Plaintiff's Exhibit 105, Mr. Ludwig. It's entitled

refractories segment, operating profit, and has the handwriting EPA-3/9/78 in the upper right-hand corner.

Can you tell me who prepared that document and when it was prepared?

A. I think it was prepared, by reason of this date on this document, on March 9, 1978, and it covers the—

MR. MADSEN: No. He asked you who prepared it and when. You testified [542] as to when. Do you know who prepared it?

A. I believe that writing (indicating)—

Q. The handwriting on the left-hand side? A. Yes.

Q. Is that Mr. Arnolt's? A. I'm trying to make a comparison here, because it looks like it would be his, though he might have been in a hurry. It's not as neat as he usually is.

MR. MADSEN: You're referring to page one of plaintiff's Exhibit 105?

THE WITNESS: Right.

Q. Have you seen the document before? A. Oh, I think so, yes.

Q. Is it your recollection that Mr. Arnolt prepared this document? A. Not my recollection, but I buy his initials on it.

Q. Is it your belief that he prepared the document? A. Yes.

Q. To the best of your recollection, is that his handwriting on the left-hand side? A. I believe it is.

[543] Q. Is this one of the documents that was prepared in order to provide Combustion with the information which you and Combustion had agreed would be provided by Basic? A. This is part of such information.

Q. Let me show you Plaintiff's Exhibit 106. A. All right.

Q. Have you seen that document before? A. I think I have seen it, but I don't have any recollection of when.

Q. Can you tell me who prepared the document and when it was prepared? A. I believe all of those were prepared by Combustion, by Insley and his people.

Q. You're referring to all of the financial statements that are included in Plaintiff's Exhibit 106? A. Yes.

Q. The document, I will tell you, has been produced to us by Basic and is numbered B-4-8.

Does that refresh your recollection as to whether it was Basic or Combustion that prepared the document? A. I still believe it was Combustion.

Q. Page five of Plaintiff's Exhibit 106 is a [544] document entitled Basic Inc. consolidated, and it appears to be a profit-loss statement for Basic for the years 1973 through 1977 with an estimate as to the profit-loss statement of Basic for the year 1978, is that right? A. Yes, that's what it appears to be.

Q. Is it your testimony that this document was also prepared by somebody at Combustion? A. Yes.

Q. Where did the information from which this page of Plaintiff's Exhibit 106 was prepared come from? A. I don't know. Can I take a look at some of these?

Q. You mean some of the prior exhibits? A. Yes.

Q. I'm not asking you to do a study of all the prior exhibits. I'm asking you if you have a recollection. A. No, I do not have a recollection, but I would be surprised, excepting for the order of some these things, if they were different than some of those others.

Q. Is it your belief that the numbers from [545] which the Basic Inc. consolidated profit-loss statement was prepared by Combustion came from Basic? A. From the information Basic provided Combustion you mean?

Q. Yes. A. Yes, in the Insley meeting, during the Insley meeting.

Q. What is the Insley meeting to which you've referred? A. Some date in March.

Q. Do you recall when that date was in March? A. I think it was toward the end, I don't know, 20 something.

Q. Who was present at what you've referred to as the Insley meeting in March? A. I believe Preston Insley of Combustion, Ted Thomas, Ed Arnolt and I, and I believe Max probably was, because he does this usually.

MR. MADSEN: No. Not what he does usually. If you remember him being there, so testify. But don't speculate.

A. I believe I remember Max stopping in to say howdy-do-de to us.

[546] MR. MADSEN: Had you finished your answer before I interrupted you?

THE WITNESS: Yes.

Q. Let me show you the document that has been marked as Plaintiff's Exhibit 20 and has been referred to as the redacted version of Mr. Muller's memory crutch. This is a document which, as you've been told previously during the deposition, was prepared by Mr. Mulier. Let me show you the entries on the document.

There is an entry for March 10 of 1978 that says, "MJL, AMC, EPA, MM reviewed financial data (3/9/78 EPA)," then it says, "Decision: proceed with meeting CE-Basic as was planned for 3/13/78".

Do you recall a meeting on about March 10, 1978 along the lines referred to in this entry of Mr. Muller's memory crutch? A. I don't recall it was March 10th independently but—

Q. Without recalling the date specifically, do you recall the meeting? A. Right. I recall these people on a review of financial data which we were to [547] gather as part of the February 27th meeting with Kelly.

Q. Which you were to gather and provide to Combustion? A. Right.

Q. You reviewed the data that had been pulled together by Mr. Arnolt? A. Yes, I believe that that's right.

Q. Do you recall making a decision to proceed with the meeting concerning Combustion Engineering and Basic as was planned for 3/13/78? A. The 3/13/78 date, as such, rings no bells with me, but I seem to recall that Insley could not make that date and eventually it turned out to be this 3/27.

Q. You mean 3/22? A. Right, 3/22.

Q. But do you recall at the meeting, which Mr. Muller's memory crutch indicates occurred on March 10, 1978, making a decision to proceed with a meeting with Mr. Insley? A. Without that, I have no recollection on that point at all.

Q. Was there some question as to whether you [548] were going to proceed with a further meeting with Combustion? A. Not in my mind.

Q. Now, Mr. Muller's memory crutch for the date 3/22/78 states, "Preston Insley, Kelly's controller, visits Cleveland, all day," and then it appears to say, "with MJL, EPA, TT, exchange 1973-1980 figures."

Is that the famous March Insley meeting to which you've previously referred? A. Yes.

Q. Do you recall spending all day exchanging figures with Mr. Insley? A. I don't recall how much time we spent together, no, as far as all day, just being technical, whether it was all day or most of the day or overtime.

Q. Do you recall spending a good portion of a day meeting with Mr. Insley exchanging figures? A. Right.

Q. Right? A. Right.

Q. Did he give you figures? A. Oh, yes.

[563] * * * * second page.

Q. The numbers that appear to the right of the textual material that you've said is not yours are also not in your handwriting, is that right? A. Right. That's a better way to state it.

Q. Let's look at the third page of the exhibit.

Is the handwriting on the third page yours? A. I believe everything on the third page is mine.

Q. Can you tell me the purpose for which you prepared the document that has been marked as Plaintiff's Exhibit 109?

First of all, tell me when you prepared it. A. Sometime after the March meeting with Insley, as to a starting time, and before the meeting with Kelly in June. * * * *

[617] * * * * A. Caito and Steinhouse had a discussion at which Steinhouse was given the assignment to determine what

if any antitrust problems would result in a combination of Basic and USG.

Q. When did that discussion take place? A. No idea. No recollection.

Q. You said that you saw an entry in your calendar that refreshed your recollection as to that discussion or that meeting? A. I don't have any recollection.

Q. You testified that Mr. Steinhouse was called in to do an antitrust investigation concerning the possible consequences of a merger between Basic and United States Gypsum? A. Yes.

MR. JEAVONS: Just a minute.

THE WITNESS: That's not quite it.

MR. JEAVONS: That isn't what he said.

[618] MS. BLAKELEY: He said a combination.

BY MR. ELKIND:

Q. What sort of combination were you referring to? A. I wasn't referring to any.

Q. A merger? A. They were just examining the antitrust consequences or problems.

Q. Well, were they examining the possible antitrust problems of a possible acquisition of Basic by United States Gypsum? A. I don't know if that's the way they were examining it.

Q. Do you have any reason to believe that's not the way they were examining it?

MR. JEAVONS: I'll object to that. He was not part of the meeting. He's told you what his best recollection is.

MR. ELKIND: I'm asking whether he has any reason to believe that was not part of what they were examining.

A. I don't have any reason to speculate on which way it was or whether that was even the point of their discussion.

[629] * * * * Q. Let me show you the entry in your calendar for June 20th, 1978.

Could you read that into the record, please? A. "AMC re USG and CE. Carl Steinhouse."

Q. Is that the entry to which you were referring? A. I believe it is.

Q. Does that entry relate to a telephone conversation that you had with Mr. Caito? A. No.

Q. Does it relate to a meeting that you had with Mr. Caito? A. Yes.

Q. How long did the meeting last?

A. I can't tell because I don't know if * * * *

[634] * * * * combination with Combustion Engineering?

A. In other words, both companies rather than just one?

Q. Yes.

MR. JEAUVONS: It's the "both" that's the key.

THE WITNESS: Yes.

A. I believe it would have been on both.

Q. Can you tell me why an antitrust study was done of both— A. No.

Q. —with respect to both companies? A. No.

Q. Do you recall whether anybody other than Mr. Caito spoke with Mr. Steinhouse about doing that antitrust study? A. I don't know if anybody besides Caito talked with him.

Q. Do you have any understanding as to why an antitrust study was done of both companies? A. No. * * * *

[980] * * * * Q. Well, the transcript indicates that the entry states, "MM (CAC) agenda CE 10.24."

Can you tell me what the entry for agenda refers to?

MR. JEAUVONS: Excuse me. It looks as though, the way the entry appears in the diary itself, it has the word agenda and then underneath that some letters which might be CE.

Q. Can you tell me what agenda refers to? A. Well, agenda, I would normally so label for an upcoming meeting,

like a board meeting or something for which agenda was required.

Q. Does CE refer to Combustion Engineering? A. Very likely. I don't know.

Q. Can you tell me what the entry for CE on that diary entry for August 22 refers to? [981] A. No idea.

Q. What was discussed about Combustion Engineering with Mr. Muller? A. I have no recollection. * * * *

Q. Let me direct your attention to the entry for August 28 on Plaintiff's Exhibit 221 beginning at 1:00 o'clock.

Could you tell me what that entry states? A. "Lunch, MM and AMC re activities during absence of MM and MJL." Absences. I think it's absences.

Q. Does that refer to the vacation that Mr. Muller took in September and October of 1978? A. I don't know. This doesn't tell me he was on vacation even. It says during absences of Muller on the one hand and Ludwig on the other hand. * * * *

[996] * * * * Q. Do you recall anything other than what you've already said about what you discussed with Mr. Rose? A. What did I already say?

MR. JEAUVONS: That it basically related to the news release.

A. No.

Q. You don't recall anything about your conversation with Mr. Rose other than the fact that it related to the news release? A. No, I do not.

Q. How about your discussion with Mr. Kondla; do you recall any thing about that? A. Same as the others.

Q. You recall that it related to the news release? A. Yes.

Q. You don't recall what was discussed though? A. No.

Q. What about the discussion with Mr. Jack Wilson? [997] A. Same thing.

Q. What about the discussion with Mr. Kelly? A. Same thing.

Q. You recall that that related to the news release? A. Yes.

Q. Do you recall what was discussed with Mr. Kelly about the news release? A. No.

Q. Did you talk with Mr. Kelly about why he was calling concerning the news release? A. I don't recall.

Q. Do you recall what else was discussed in your conversation with Mr. Kelly? A. I do not. * * * *

**Excerpts from the Examination of Mathew J. Ludwig
by the SEC**

[88] * * * * Q. Prior to 1977 what was your understanding of Basic's position with respect to the possible sale to Combustion Engineering? A. We were not interested in selling to Combustion or anyone.

Q. Had you ever discussed the price at which you would sell or would consider selling Basic to Combustion or to anyone else? A. No. I don't have any recollection.

Q. Why weren't you interested at that time? A. Why?

Q. Yes. A. Because we felt that we could do better operating as [89] a separate entity or as an independent entity. * * * *

[173] * * * * Q. Who had initiated this meeting? A. My recollection is that Max Muller had. He apparently heard from Kelly he was coming to visit Tyler and he said, "Why don't you stop in," or words to that effect.

Q. What was the purpose of this meeting? A. We had an idea that we would like to explore with Combustion the possibility of acquiring, of our acquiring the Refractories Division.

[96] * * * * Q. What do those entries indicate? A. I'm pretty sure all of these relate to an agreement that was proposed between a Canadian operation of Combustion and ours under which that operation would sell on a commission basis certain of our U.S. products in Canada; also there would be a license agreement to Combustion—and I don't remember whether they were one in the same document or not—and this was to manufacture in Canada certain products which, as I [97] recall it, would be more efficiently manufactured in Canada because there is a lack of duty that applies to products going from here to Canada.

BY MR. WACHTERMAN:

Q. Did you participate in the negotiation of that agreement? A. I did not participate in the negotiations. Contracts are part of my area of operation, whereas I was not in the negotiating line, but Mr. Caito was. I think the name of the Canadian Combustion manager was Bennett.

Q. Bennett? A. Yes. I don't recall who was trying to persuade who to enter into this agreement. It eventually collapsed anyhow because the commission rates we proposed were not satisfactory to Mr. Bennett.

Q. Was Mr. Kelly involved in the negotiations of this agreement? A. Kelly?

Q. Yes. A. I don't believe he was.

Q. You don't? A. No. I think this was strictly between Caito and Bennett. * * * *

Q. The meeting was to explore that possibility? A. Yes.

[174] Q. And at this meeting did you relate that purpose to Mr. Kelly? A. Yes.

Q. What was his reaction to that? A. I think he was a little surprised, but nonetheless agreed to provide us with the information which would permit us to make a judgment on whether we felt it was something that did fit our situation and that not only product-wise, but dollar-wise.

Q. Was there anything else discussed at that meeting? A. While, well, it was at that meeting that Mr. Kelly agreed to provide the information we thought necessary for us to make such a judgment, which was volume, profits, plant investment, by the several locations they had.* * * *

BY MR. MEADOWS:

[225] * * * * Q. Referring to your calendar, directing your attention to November 27th, there is an entry "MM Re: Segal", and what does that notation mean? A. I believe it means, or it is related to the idea that we ought to get Mr. Segal in; arising out of the preceding entry, which was a meeting on the same day with [226] Jim Kelly, Muller, Cato and me.

Q. Why was it you wanted to get Mr. Segal in at this point? A. Well, at this meeting, Kelly indicated that they were still interested in Basic and we kicked around the idea of a possible offer of shares or combination of shares and cash and Muller said, "Anything that he might want to present, that he, Kelly, might want to present would require a look by Kidder, Peabody as far as we were concerned", and I believe Kelly suggested maybe Kidder and First Boston might get together and make some kind of a joint evaluation, but I don't have any recollection of why that didn't seem like such a good idea, but in any case, it would have been Segal who probably would have spearheaded the valuation and it was in that connection that I said, "Maybe we had better try to get ahold of him".* * * *

**Excerpts from the deposition of Theodore Mayer
by Respondents**

[82] * * * * BY MR. ELKIND:

Q. How many calls did you make to Basic's offices during the year 1978? A. Quite a few.

Q. More than twenty? A. Probably.

Q. To what persons did you speak when you made those calls? A. Jeff Collins, Max Muller, and perhaps Mr. Ludwig, but not necessarily in 1978.

Q. How many calls did you make to Basic's offices in 1977, as best you recall? A. Probably quite a few.

Q. More than twenty? A. It could have been more than twenty. * * * *

[243] THE WITNESS: I don't remember any specific conversation with all of that detail.

BY MR. ELKIND:

Q. Do you recall that being discussed?

MR. FAIRBANKS: Recall what?

MR. JEAVONS: Objection.

MR. STERNMAN: It's the same question.

MR. FAIRBANKS: He said he didn't recall a discussion with all the things that you had in the question in it.

BY MR. ELKIND:

Q. Let me try to refresh your recollection, Mr. Mayer. I direct your attention to your SEC testimony on page 154, lines 8 through 12.

The page numbers refer to the transcript as it's been produced to us.

"Q. Did you ever discuss with anybody from Basic at

any time the possibility that Basic might merge, be taken over, or be acquired by any other company?

"A. That came up over a long period of time on several occasions."

[244] Do you have any reason to believe that does not fairly and accurately reflect your testimony before the SEC?

A. No. Particularly when I read lines 21 through 23 that, "it would have come up in one of my phone contacts asking if any acquisition-hungry companies or acquisition-minded companies may have approached him."

Q. Mr. Mayer, you are reading from lines 21 through 23 of your testimony? A. Yes. * * * *

[245] * * * * Q. I will read the question and answer, Mr. Mayer:

"Q. Did you ever discuss with anybody from Basic at any time the possibility Basic might merge, be taken over, or be acquired by any company?

"A. That came up over a long period of time on several occasions."

Is that testimony accurate? A. It is to the extent that I responded to one part of the question indicating that one of the questions that I would ask frequently, something that would have come up in one of my phone contacts, asking if any acquisition-hungry companies or acquisition-minded companies may have approached him. That is a stock question of mine.

Q. That is a stock question when you call the **[246]** management of a corporation? A. Of many companies.

Q. Did you, from time to time, address that question to the management of Basic? A. I believe so.

Q. To what persons in the management of Basic? A. Max Muller certainly. I may—

MR. STERNMAN: I'm going to ask you not to speculate.

A. Max Muller, as best I can recall.

Q. Do you recall whether you also discussed that with Mr. Collins? A. I don't recall that.

Q. Mr. Ludwig? A. I don't recall discussing it with him.

Q. Mr. Thomas? A. I don't recall discussing it with him either.

Q. In response to your inquiries, what kind of information were you given by Mr. Muller? A. The stock response; there have been companies interested in him.

[247] Q. That's a stock response? A. Yeah; that's a standard response.

Q. Is it your experience when you call up a public company the management has a practice of, companies have a practice of telling you that the company had been contacted by other companies? A. They tell any analyst that asks the question, they respond to it.

Q. If the company has, in fact, been approached by some other company, is that something that the management of a company, in your experience, would ordinarily disclose to an analyst?

MR. FAIRBANKS: Objection. I don't understand the question at all. We are getting into some general thing. We started with discussions with Max Muller and now we are into some generalized response he gets from discussions—
* * * *

[249] * * * * Q. Mr. Mayer, can you recall the name of any other public company whose management advised you that the company had been approached by another company?

MR. FAIRBANKS: Object and instruct the witness not to answer.

[250] * * * * Q. Mr. Mayer, to your knowledge, did Basic at any time prior to December 18, 1978 make a public disclosure that, to the effect that it had been, that it had been approached by another company? A. Not that I can recall. * * * *

[253] * * * * Q. Mr. Mayer you referred to what you de-

scribe as "a stock response". What is the stock response to which you referred that you received when you made inquiries to other companies as to whether they had or had not been approached?

MR. FAIRBANKS: The stock response he got from Basic or a more general stock response?

MR. ELKIND: A more general question.

THE WITNESS: It's usually answered in the past tense.

BY MR. ELKIND:

Q. What is answered in the past tense? A. That question. Yes, we have been approached, past tense. * * * *

[255] * * * * Q. When was the first time that you asked Mr. Muller whether Basic had been approached by other companies interested in a possible merger with Basic. A. I don't recall.

Q. Would it be prior to the date of your January 1978 progress report on Basic? A. I don't recall.

Q. Was it prior to your June 1978 wire on Basic? [256] A. I don't recall specifically when I asked that question.

Q. Let me read from your testimony before the SEC beginning on page 156, line 15:

"Q. I'm asking you for the first time you asked it. That hasn't been clear and if you want to change any answer, please indicate that.

"A. I believe to the best of my recollection I would have asked that question prior to that June wire.

"Q. Do you have any feeling as to how long prior to that wire you would have asked him that question, if it was a couple of days before or a month before?

"A. As I recall, it would have been months before.

"Q. And yet subsequent to your July 1978 progress report—"

MR. FAIRBANKS: That's obviously means January '78.

"Q. —January '78 progress report on Basic, Inc.—

"A. Give me that date again.

[257] "Q. January 1978 progress report on Basic Inc.

"A. I may even have asked him prior to that. I just can't recall the exact date, you know, of my first inquiry." * * * *

* * * * Q. Mr. Mayer, do you have any better recollection than what is reflected in that testimony that I have read as to when you first addressed the question to Mr. Muller? A. No.

Q. When you first asked Mr. Muller if Basic had been approached, what did he tell you the first time you asked him the question? A. I really don't recall.

Q. Let me read to you from lines 5 through 10 on page 157 of your SEC testimony:

"Q. The first time you asked Mr. Muller about [258] any possible merger conversation with any company, what did he say?

"A. He indicated to me they had experienced inquiries from companies interested in acquiring Basic, or, at least, engaging in exploratory talks."

Do you have any reason to believe that does not accurately reflect your testimony before the SEC? A. No.

Q. Do you have any reason to believe that any of the testimony that I have read from page 156, line 15 through page 157, line 10, does not accurately reflect your testimony before the SEC? A. No.

Q. Does the testimony on lines 8 through 10 refresh your recollection as to what response Mr. Muller gave you the first time you asked whether any company had expressed an interest in acquiring Basic? A. No, it doesn't refresh my recollection.

Q. The testimony continues beginning on line 11, page 157:

"Q. What did you say during that conversation [259] when he said that?

"A. I listened. You know, that was a good answer."

Do you have any reason to believe that does not accurately reflect your testimony before the SEC? A. No. * * * *

* * * * Q. Do you have any reason to believe that the testimony between lines 5 and line 13 on page 157 does not accurately reflect what actually transpired in that first conversation with Mr. Muller? A. No. * * * *

[260] * * * * Q. You understood the question that way, did you not, sir?

A. I hope so.

Q. Is it your practice, Mr. Mayer, when you address—strike that.

Is it your practice when you ask corporate officers whether their companies have been approached by other companies to ask them for, ask them for the identity of the other companies that have expressed an interest, possibly expressed an interest in the company? A. No, it's not my practice.

Q. Why is it not your practice? A. It's of no interest to me.

Q. Is that the only reason? A. That's the reason that keeps me out of trouble with the SEC.

[261] Q. Isn't one of the reasons that you don't ask that question the fact that you don't want to compromise the officers of the companies? A. That is another reason.

* * * * Q. Let me read from your testimony before the SEC, Mr. Mayer, beginning on line 21 of page 157:

"Q. I asked whether you asked him for the names of any of those companies at that time, the first time you spoke with him on the subject?

"A. I don't believe I asked him for any names.

"Q. Why not?

"A. I try not to compromise officials at companies."

* * * *

[262] Q. Do you have any reason to believe that does not accurately reflect your testimony before the SEC? A. No.

Q. What do you mean when you say that you try not to compromise officials at companies? A. All I'm interested in in asking that question is to establish value because all major

corporations have departments, people who are designated to seek out values, and that's a confirmation of my opinion, and that is why I asked the question.

Q. Do you deem it to be—strike that.

My question to you, sir, is: What do you mean when you say you try not to compromise officials at companies by asking them for the names of the companies? A. That's asking for inside information. I don't do that.

Q. You consider the names of the companies that have approached a company to be inside information? A. Even if it's in the past.

[269] * * * * Q. Mr. Mayer, do you consider yourself experienced in communicating as an analyst with corporate management?

MR. STERNMAN: Same objection.

A. I certainly have long experience talking with corporate management.

Q. Over how many years have you gathered that experience? A. I'd say since the late 1960's.

Q. You have been an analyst of companies since the late 1960's? A. Primarily. * * * *

[272] Q. Following the first conversation that you had with Mr. Muller about the interest of other companies, did you have subsequent conversations with them about the interest of other companies in possible merger or acquisition with Basic?

MR. JEAONS: Conversations or inquiries by Mr. Mayer?

THE WITNESS: Yes.

BY MR. ELKIND:

Q. Over what period of time? A. I can't recall specifically.

Q. Do you recall that you had such communications with

them on more than half a dozen occasions? A. Certainly more than once.

Q. Let me ask you to read your testimony on page 159 from lines 7 through 25.

(There was a pause for document examination.)

Q. Do you have any reason to believe that does not fairly and accurately reflect your testimony before the SEC?

A. No.

Q. Does that refresh your recollection in any way as [273] to how many times you asked Mr. Muller whether Basic had been approached by other companies? A. No.

Q. Do you have any reason to believe that your statement, "I believe it was more than half a dozen times," at the bottom of page 159 is in any way inaccurate? A. No.

Q. When was the last time you had a conversation with Mr. Muller in which he indicated that Basic had been approached by other companies? A. I don't recall. * * * *

[274] * * * * Q. Do you recall how many months prior to the December 20 tender offer announcement the conversation occurred in which Mr. Muller indicated that Basic had been [275] approached by other companies? A. No.

Q. Can you give me any estimate of the time frame in relation to the December 20, 1978 announcement of the tender offer? A. No, I cannot.

Q. Do you recall—strike that.

Do you recall telephoning Mr. Muller in September or October of 1978 because of the trading activity in Basic's stock and a rumor of a West German company that was about to make a tender offer for Basic? A. I have a vague recollection of a conversation around that time.

Q. Can you tell me why you made that telephone conversation to Mr. Muller? A. Not at this point.

Q. Let me direct your attention to the testimony you gave which appears at pages 230 beginning on line 22 through 231 before the SEC. * * * *

[276] * * * * Q. Let me read from page 230 beginning on line 16:

"Q. Did he," referring to Mr. Muller, "ever from that point on ever mention to you anything else about the three foreign companies that had made inquiries about Basic?"

"A. I don't believe he mentioned it to me but I believe I mentioned it to him later that year.

"Q. When was that?"

"A. It was either September or October.

"Q. Did you call him?"

"A. I called him.

"Q. What was the purpose of your call?"

"A. Trading activity again in the stock, rumors of, where a rumor that a West German was going to bid \$40 a share for the company.

"Q. Where did you hear that rumor?"

[277] "A. I can't recall that one at this point in time where I heard that.

"Q. Was that the extent of the information that you had that a West German company was going to bid \$40 a share for Basic?"

"A. Yes, I believe so.

"Q. Was that in the latter part of September?"

"A. I can't remember specifically. It was either September or October. It was in that general time frame, the stock was active.

"Q. It was coincident with the stock being active and higher I take it?"

"A. Or just active. Activity is enough to make me interested.

"Q. What, if anything, did Mr. Muller say about that information?"

"A. I don't remember the specifics of that conversation but I recall that he responded that people are always interested in us."

MR. FAIRBANKS: Do you want to read the next question and answer?

[278] BY MR. ELKIND:

"Q. Was it your impression at the time that this West German company in September or October was the same West German company that you talked to Mr. Muller about in September of 1978?"

"A. I don't form any impressions. I just pass the rumor back to see his response."

Do you have any reason to believe that does not accurately reflect your testimony before the SEC? A. No.

Q. Does that refresh your recollection as to the substance and timing of your discussion with Mr. Muller? A. No.

Q. Do you recall the events that are set forth in that testimony? A. I have a vague recollection of that conversation.

Q. Do you recall anything that is in any way inconsistent with that testimony? A. I can't recall anything inconsistent with that testimony.

Q. Is it your belief that that testimony is truthful [279] and accurate? A. Yes. * * * *

[283] * * * * Q. Do you recall a conversation with Mr. Muller sometime between July and December 1978 in which you discussed the subject of the possible interest of other companies in acquiring Basic? A. I have a vague recollection of such a discussion.

Q. Can you tell me what was discussed during that— A. I can't remember any specifics.

[284] Q. Do you recall asking Mr. Muller whether there had been inquiries from companies interested in acquiring Basic? A. I can't remember asking that question.

Q. Let me refer you to your SEC testimony on pages 166 and 167 of what has been produced to us to see if I can refresh your recollection beginning line 12 on page 166 which says:

"Q. What was the substance of this conversation that occurred sometime between July and December, probably two or three months before December, as you recall?"

“(Witness and counsel consulting.)”

"THE WITNESS: I can't remember the conversation specifically or exactly what was discussed in the conversation but I believe that I asked have there been any inquiries from companies interested in acquiring Basic.

"BY MR. WACHTERMAN:

"Q. Do you recall anything Mr. Muller said during that conversation?

"A. There are always companies interested in Basic.

"Q. Is that what he said?

[285] "A. Yes, that is what I recall.

"Q. Did he say anything else during that conversation?

"A. Not that I can recall.

"Q. In this conversation with Mr. Muller between July and December, did you ask him the name of any of those companies?

"A. No.

"Q. Did he indicate in any way the names of those companies?

"A. Not in that conversation.

"Q. Did he indicate in any way the status of any merger or acquisition negotiations?

"A. No.

"Q. Did he say anything beyond the fact there were companies interested, always companies interested in Basic?

"A. He indicated if an announcement was required one would be made.

"Q. Did he say anything else during that conversation about the possibility that Basic might merge?

[286] "A. Not that I can recall."

Do you have any reason to believe that does not accurately represent your testimony before the SEC? A. No.

Q. Does that refresh your recollection as to a conversation which you had with Mr. Muller sometime between July and December of 1978? A. No.

Q. Do you recall Mr. Muller telling you at that time, at the time of such a conversation, that there are always companies interested in Basic? A. No.

Q. Do you remember him saying that if an announcement was required one would be made? A. I don't recall that either.

Q. Do you recall him making that comment on any occasion? A. I have a vague recollection that that comment was made to me at some time.

Q. Can you tell me when that comment was made to you? [287] A. I can't recall.

Q. Can you tell me the circumstances in which the comment was made? A. I can't remember the circumstances. * * * *

A. No.

Q. Did Mr. Muller indicate to you any reason for the [288] comment that if an announcement was required one would be made? A. I have no idea how to answer that question.

Q. Is that because you don't recall or what? A. I find the question is confusing to me. Would you repeat the question?

Q. Certainly, sir.

My question is whether Mr. Muller during the course of the conversation in which he said that if an announcement was required one would be made indicated to you any reason for making that comment. A. Not that I can recall.

Q. Do you recall over what period of time you addressed inquiries to Mr. Muller as to whether Basic had been approached by companies interested in a possible acquisition of Basic?

MR. JEAUVONS: May I have that question read?

(The Reporter read the pending question.)

A. I don't have a specific recollection of that time frame.

Q. You do recall making such inquiries to him from [289] time to time? A. Yes.

Q. Do you recall the number of occasions on which you made such inquiries? A. A number of times, but I can't remember a specific number.

Q. Can you give me any approximation of the time period over which you made such inquiries? * * * *

THE WITNESS: It was within, a segment within the time frame of recommending the stock initially and

when the stock no longer existed as a public company. As to what period within that period I cannot be more specific.

BY MR. ELKIND: * * * *

[290] * * * * Q. Do you recall that you made those inquiries to Mr. Muller over a period of months? A. Yes.

Q. Let me read you from your SEC testimony on page 168 beginning line 9:

"Q. Did you ever have any over conversations with Mr. Muller in which you asked him about inquiries being made about Basic, Inc. and its merging or the possibility that Basic, Inc. might merge or be acquired?

"A. Yes.

"Q. When was the one—when did that occur?

"A. Over an extended period of time."

Do you have any reason to believe that does not fairly and accurately represent your testimony before the SEC? A. No.

Q. Does that appear to you to be an accurate statement of facts?

[291] A. If it's in the transcript, I believe it is.

Q. What kind of a response did Mr. Muller generally give you when you made those inquiries to him?

MR. STERNMAN: Object to any generalizations in testimony. I don't think you have shown there were any generalizations that were made.

Q. What kind of a response did Mr. Muller give you when you addressed those inquiries to him? A. I can't give you a specific answer as to his exact response, but I took it as being a response within a universe of stock responses that I get from people. You must understand that it's my belief, and has always been my belief, that the great majority of acquisition inquiries are really frivolous in nature. There is no serious intent on the part of the people making the inquiries to proceed with an acquisition. You have to keep that in mind.

When people, companies, managers of companies, give the stock answer, it means to me that they have had inquiries over a lengthy period of time, perhaps years. I would have to say in most instances they would be over periods of years. So when I hear that response, that [292] doesn't register as being meaningful to me because those old and historical or stale inquiries really are not important.

Q. It's your testimony that the responses that you received from Mr. Muller in your mind were stock responses of no particular significance to you? A. That's the impression that I had at that time.

Q. You didn't deem those responses to be of any particular significance to yourself? A. No. It just confirmed to me that other people, at least, had looked at the company and had confirmed, you know, my interest in the company as an analyst thinking there were good values there.

Q. You didn't immediately relate those responses to the salesmen of Legg Mason?

MR. JEAVONS: Object to the form of the question.

MR. FAIRBANKS: I object also.

Q. Did you immediately relate the responses you got from Mr. Muller to the salesmen at Legg Mason?

MR. JEAVONS: Objection.

MR. FAIRBANKS: Object.

[293] A. I don't recall.

Q. Did you bring information that you got from Mr. Muller to the attention of the Legg Mason salesmen within a couple of days or a couple of days after you received the responses? A. Could you clarify that, what information?

[298] * * * * Q. Mr. Mayer, referring you to lines 8 through 10 of your testimony on page 180, did Mr. Muller inform you from time to time that, "there have been inquiries"?

MR. FAIRBANKS: Objection; instruct him not to answer. He already said as far as he knows that is an accurate transcription of what he said there. And he [299] answered that question a number of times here yesterday and already this morning.

MR. ELKIND: I'm trying to pin down as to what—

MR. FAIRBANKS: He has given you his best recollection on a half dozen occasions.

MR. ELKIND: I'm trying to pin down—

MR. JEAVONS: Ask a different question.

BY MR. ELKIND:

Q. Mr. Mayer, sitting here today, do you have a recollection Mr. Muller informed you from time to time there had been inquiries to Basic by companies interested in an acquisition of Basic? A. From time to time Mr. Muller informed me there had been companies interested in acquiring Basic.

Q. Did you have a conversation with Mr. Muller in July of 1978 in which he indicated to you the names of some of the companies that had expressed an interest in acquiring Basic?
* * * *

[300] * * * * Q. Mr. Mayer, did you have a conversation with Mr. Muller in July of 1978 in which he indicated to you the names of some of the companies that expressed an interest in acquiring Basic? * * * *

Q. Did you have a conversation with Mr. Muller in July of 1978? [301] A. I believe so. * * * *

[302] * * * * Q. Did Mr. Muller identify for you during that conversation companies that expressed an interest in acquiring Basic?

MR. FAIRBANKS: Objection, same ground. * * * *

[304] * * * * Q. Did you have a discussion with Mr. Muller in July of 1978 in which the names of the Eaton Corporation and TRW were discussed? A. I have a vague recollection of that call, that conversation.

MR. STERNMAN: Mr. Mayer, from something that [305] was said, possibly while you were out of the room, I think the date in that question was critical to Mr. Elkind. Did you focus on the date when you answered? Do you have a recollection of that conversation in July of 1978?

THE WITNESS: No; but when I was asked to read my testimony at the SEC this morning, I noticed two dates in the testimony in the month of July, but they don't mean anything to me at this point.

BY MR. ELKIND:

Q. Did Mr. Muller, during the course of the conversation to which you just referred, indicate to you that companies had expressed an interest in acquiring Basic?

MR. FAIRBANKS: I will object to the question. If you want to ask him who said what to whom in that conversation, fine. But I don't think you ought to be able to suggest what was said.

MR. ELKIND: I'm not suggesting anything. Mr. Mayer, you can answer that question in your own words as to what was discussed in the conversation.

MR. JEAVONS: Note my objection.

MR. FAIRBANKS: The question is who said what [306] to whom in that conversation.

THE WITNESS: I can't recall the specifics of that conversation although I have a recollection that the names of Eaton and TRW were mentioned in the conversation as two companies that had at some time in the past—that was never told to me—expressed an interest in Basic, Incorporated.

MR. ELKIND: In acquiring Basic?

MR. JEAVONS: Objection.

THE WITNESS: I believe so.

BY MR. ELKIND:

Q. Were the names of any other companies mentioned during that conversation? A. I don't recall any other names being mentioned.

Q. Were references made in that conversation by Mr. Muller to the fact that other companies had expressed an interest in Basic? A. I have a vague recollection that that probably was mentioned.

Q. Tell me what was mentioned in that regard? A. I think reference was made to three foreign [307] companies.

Q. Three foreign companies that had expressed an interest in acquiring Basic? A. I believe so. * * * *

[308] * * * Q. Do you see the reference to a telephone call made to Cleveland, Ohio on July 10? A. Yes.

Q. That was a two-minute call? A. Yes.

Q. Do you see a reference to a telephone call to Cleveland, Ohio made on July 12? A. Yes.

Q. A four-minute call? A. Yes.

Q. Were those calls that were made to the offices of Basic, Incorporated? [309] A. I believe that is Basic's phone number.

Q. Were those the calls that, in which you had the discussion with Mr. Muller to which you just testified? A. I believe so, but I can't be one hundred percent sure. * * * *

Q. Do you see the reference to the telephone call on July 27th to Cleveland, Ohio? A. Yes.

Q. A six-minute call? A. Yes.

Q. Do you know whether that is a call to which you referred? A. I can't recall at this point.

Q. Mr. Mayer, is it your best present recollection that the call to which you just testified was one of the [310] first two calls, either on July 10th or July 12th?

MR. FAIRBANKS: He already said he doesn't have any recollection. I'm not sure I understand the question.

MR. ELKIND: I'm trying to probe what his present recollection is, Joe.

MR. FAIRBANKS: He has none; he already testified to that. The best of none is—

BY MR. ELKIND:

Q. Let me see if I can refresh your recollection. Let me direct your attention to your SEC testimony, to pages 169 through 170 of the portions of transcripts that have been produced to us. Do you have those pages? A. Yes, I do.

Q. I will read beginning line 1 of page 169:

"THE WITNESS: My telephone records indicated that I spoke with Max Muller or somebody at Basic three times in the month of July.

"Q. Do those records in any way refresh your recollection as to when you spoke to him about inquiries about a Basic merger or the possibility that Basic might [311] merge, this conversation you are referring to.

"A. As far as I can recall, I believe it was one of the first two calls, one of which occurred on July 10th and the other of which occurred on July 12th. I can't recall which of those calls I asked that question.

"Q. Why do you believe it was one of those two calls as opposed to the third?

"A. I just recollect that it was earlier in the month than later in the month.

"Q. When was the third call?

"A. The third call was July 27th."

Do you have any reason to believe that that is not an accurate reflection of your testimony before the SEC? A. No.

Q. Do you have any reason to believe that the facts as testified to therein are in any way inaccurate? A. No.

Q. Did you initiate the telephone call to Mr. Muller to which you referred? A. I'm uncertain.

Q. Let me direct your attention to your testimony at [312] pages, on page 170 beginning on line 5. It says:

"Q. Is there anything about the trading activity in Basic, Inc. during that period of time which led you to make that call or calls?

"A. I believe that is why I initiated the call.

"Q. Would you explain to me why you initiated the call?

"A. The trading activity in the stock, and I can't remember the specifics of the trading activity, looked unusual to me and I called and asked whether they had any inquiries from companies interested in acquiring Basic.

"Q. You spoke to Mr. Muller?

"A. Yes, I did.

"Q. What did Mr. Muller say?

"A. He indicated that they had had inquiries."

Does that refresh your recollection as to whether you initiated the call? A. No.

Q. Do you recall what Mr. Muller said to you—I'm sorry, do you recall what you said to Mr. Muller after Mr. Muller indicated that Basic had had inquiries? [313] A. I don't recall.

MR. JEAVONS: Did you say had had inquiries?

MR. ELKIND: Yes.

MR. FAIRBANKS: Yes, that is what he said.

BY MR. ELKIND:

Q. Let me read you from your testimony beginning on line 16 of page 170, which says, and I quote:

"Q. What did Mr. Muller say?

"A. He indicated that they had had inquiries.

"Q. Mr. Mayer, did he say anything else besides that they had had inquiries?

"A. I asked him like who.

"Q. I thought you told me earlier that you never asked that question?

"A. That time I did. That's why I have the specific recall. He answered.

"Q. What did he say?

"A. He indicated three foreign companies and didn't identify them by name, and two other domestic companies which he did identify by name.

"Q. What were the names of the two domestic [314] companies that he named?

"A. I believe he said Eaton and TRW."

Do you have any reason to believe that does not fairly and accurately reflect your testimony before the SEC? A. No. * * * *

[315] * * * * Q. Let me refer you to all the testimony that I read you on pages 169 and 170 through 171. Do you have any [316] reason to believe that any of that testimony that I read over the course of this whole series of questions is in any way inaccurate? A. No.

Q. Or that it does not accurately reflect your testimony before the SEC? A. No. * * * *

Q. Do you recall asking Mr. Muller during the course of the conversation for the names of the companies that had [317] expressed an interest in acquiring Basic? A. No. * * * *

[318] * * * * Q. Let me read from your testimony page 171, line 1—we will start with line 9:

"Q. Did he say anything else during that conversation besides naming the companies that had been inquiring?

"(Witness and counsel consulting.)

"THE WITNESS: I asked him another question. I indicated there was a rumor around that the company was going to be acquired by a West German company and that the rumor had as its source a Washington attorney.

"(Witness and counsel consulting.)

"THE WITNESS: Who was a customer of Merrill Lynch. * * * *

[332] * * * * BY MR. ELKIND:

Q. Did you take steps, either the same day or the next day, after your telephone conversation with Mr. Muller to relate the information which you had received from him to brokers at Legg Mason? A. I would have no idea at this point.

Q. Let me direct your attention, Mr. Mayer, to your testimony on page 310 of your transcript before the SEC.

(Documents tendered.)

MR. ELKIND: Let me ask you to read your testimony on pages 309 and 310.

(There was a pause for document examination.)

THE WITNESS: Beginning where?

MR. ELKIND: Beginning on the line up at the top of page 309, which would be line 14, through the end of page 310.

(There was a pause for document examination.)

BY MR. ELKIND:

Q. Let me read it to you:

"Q. Mr. Mayer, you testified earlier in your [333] testimony, and it has been mentioned today, that Mr. Muller on or around July 10, 1978 or July 12, 1978 gave you certain information about Eaton Corporation, TRW and three unnamed foreign companies and expressed an interest in acquiring Basic, Incorporated. Is that correct?

"A. I don't remember the word acquiring but having expressed an interest in Basic at some prior period like the prior year.

"Q. Mr. Muller in sworn testimony before the staff of the Commission has denied ever discussing with you Eaton Corporation, TRW or unnamed companies expressing an interest in Basic, Incorporated. Do you have

any other information which you can provide to the staff to substantiate the statements you have made regarding what Mr. Muller said?

"A. No, only my recollection that he said it.

"Q. During one telephone conversation?

"A. In July.

"Q. No other time?

"A. I don't believe it came up again.

"Q. No one else was present?

[334] "A. No.

"Q. With respect to persons whom you told that information to and told the source of that information, there has been prior testimony concerning that and I just want to go over that with you.

"A. Yes.

"Q. You did tell the sales meeting, the phone hookup, subsequent to your phone conversation with Mr. Muller, immediately subsequent, I think you said, the next Tuesday after, whatever it was.

"A. I believe I told them as soon as possible.

"Q. Correct. And you used the names Eaton, TRW and unnamed foreign corporations?

"A. Yes.

"Q. Telling that phone hookup that information?

"A. Yes.

"Q. You told them that that source of information was the president of Basic?

"A. I believe so."

Does that refresh your recollection as to—

MR. FAIRBANKS: Read the next one too to get [335] the record clear.

BY MR. ELKIND:

"Q. Did you mention Mr. Muller's name or did you just—

"A. I may have said, 'In a contact with Basic, Incorporated I learned this.' I'm not sure I mentioned his name specifically but I may have or may not have. It's been so long that I can't recall now.

"Q. And why did you tell in that phone hookup, to the sales hookup, why did you give that, why did you give them that information?

"A. Because it reinforced my original recommendation. It's an interesting, the company was an interesting acquisition candidate.

"Q. And the fact that these named companies and unnamed companies had made an acquisition—

"A. Confirmed my belief.

"Q. That's why you told it to them?

"A. Yes."

MR. JEAVONS: I think it would be fair to go through the next several questions and answers.

**Excerpts from the Examination of Theodore Mayer
by the SEC**

[1839] BY MR. WACHTERMAN:

Q. Mr. Mayer, Mayer Exhibit 2 are telephone records of your telephone, 269-4184. They indicate calls from that telephone to area code 203-324-9300, Stanford, Connecticut, on December 29th, 1977 and January 3rd, 1978.

I think you've indicated earlier that that is the telephone number of Flintkote, is it not? A. I don't remember. But, is there some way I can check it?

Q. I have satisfied myself that it is.

MR. FRANK: You don't recall whether it is or it isn't. It either is or it isn't.

BY MR. WACHTERMAN:

Q. To the extent that it is Flintkote's telephone number and that's easily ascertainable and I have ascertained it, why were you still in contact with Flintkote as late as January 3rd, 1978? A. I can't recall exactly.

Q. Was there any reason other than your interest in a Flintkote—Basic merger that would have prompted you to be in contact with them as late as January 3rd, 1978? **[1840]** A. I don't believe there would have been any other reason.

Q. In any contact subsequent or as late as January 3rd, 1978, such contact would have followed the newspaper article about Flintkote and Basic and your receipt of it, would it not have? A. I believe so.

Q. Do you have any recollection of any conversation with Mr. Waddell about that newspaper article? A. At this time, I don't have any recollection of any conversation with him about that article.

Q. Did you have any discussions with Mr. Waddell in any way relating to Basic being acquired by any other company besides Flintkote? A. Could you be more specific in that question?

Q. No. A. I indicated that it was an attractive acquisition candidate and that it would be of interest to many companies.

Q. Did you ever indicate any names of companies to Mr. Waddell that might be interested in Basic, Inc.? A. Not that I can remember at this time.

Q. Getting back to your meeting at Basic, Inc. with Mr. Ludwig— A. Ted Thomas.

Q. Mr. Thomas and Mr. Muller. That was your only **[1841]** in-person contact with those gentlemen, is that correct? A. Yes.

Q. Ever? A. Yes.

Q. At the meeting that you had with those gentlemen, did

you have any discussions concerning the possibility that Basic might be acquired by somebody? A. Not that I can recall.

Q. At that meeting with those gentlemen, did the possibility of Basic being acquired in general ever receive discussion? A. I don't remember that it received discussion.

Q. After that meeting, did you have lunch with Mr. Muller? A. Yes.

Q. Where did you have lunch? A. At a restaurant of his choice. I don't remember the name of the restaurant.

Q. How long did you have lunch? A. It extended beyond an hour.

Q. Just you and Mr. Muller present? A. As I think back, I believe Jeff Collins may have joined us.

Q. How did you get to the restaurant? A. I think we walked to it.

[1842] Q. Did Mr. Collins walk with you or did he come at a later time? A. It's hard for me to recall, but I think we walked together as a group.

Q. Anybody else? A. I don't remember anybody else being at the luncheon.

Q. What did you discuss during lunch? A. I can't recall any specifics beyond, you know, general conversation of Basic, Incorporated.

Q. That's the total extent of your recollection on that subject? A. Yes.

Q. Did you have any discussions at lunch with Mr. Muller concerning the possibility that Basic might be acquired or merged with somebody? A. I don't remember discussing that with him.

Q. What did you do after lunch with Mr. Muller? A. I can't remember whether I returned to his offices to continue our discussion, or whether we terminated our meeting at that point and I left for New York.

Q. What time did you leave for New York? A. I can't remember.

Q. Do you recall any further discussions with Mr. Muller other than what you have told us so far on that day in person?

[1843] A. No, none that I can recall.

Q. Did you have any agreements with Mr. Muller as to further contacts between the two of you? A. We did have an agreement, but I indicated I would remain in touch with the company.

Q. What did he say? A. Fine.

Q. Did you ever discuss with anybody from Basic at any time the possibility that Basic might merge, be taken over, or be acquired by any company? A. That came up over a long period of time on several occasions.

Q. Why don't you explain to me when it first came up and the circumstances? A. I can't, you know, recall the exact date it came up.

Q. Well, to the best of your recollection, Mr. Mayer. A. One of the questions that I ask companies frequently when—in my telephone contacts—

(Witness and counsel consulting.)

THE WITNESS: It would have come up in one of my phone contacts asking if any acquisition-hungry companies or acquisition-minded companies may have approached him.

BY MR. WACHTERMAN:

Q. With whom was this telephone conversation? [1844] A. Max Muller.

Q. What prompted you to ask Mr. Muller about whether any companies had approached? A. It's a question I ask frequently of companies.

Q. Did you ask him that during your meeting with him at Basic? A. No.

Q. Well, why not? A. Because that initial meeting was to complete a report on the company and issue the report.

Q. How soon after the meeting did you ask him this question on the telephone? A. I can't recall.

Q. Was it in 1977 or 1978? A. I can't recall with any, you know, certainty.

Q. Was it in 1978 or 1979? A. I remember asking in 1978 about inquiries specifically, you know, in that year.

Q. Was it before or after your progress report on Basic, Inc.? A. The progress report was early in 1978, so it would be subsequent to the progress report.

Q. But other than that, you don't know if it was November, December, June, what season it was in? A. No.

[1845] Q. Was it prior to the announcement of a merger between Basic, Inc. and Combustion Engineering? A. Yes.

Q. Was it prior to the time of a denial by Basic, Inc. about any corporate developments which would explain activity in the stock in September of 1978? A. Yes.

Q. Was it prior to your June 28th wire to Legg Mason offices concerning Basic, Inc. being a good purchase at that time?

(Witness and counsel consulting.)

THE WITNESS: I have asked that question on more than one occasion of the company.

BY MR. WACHTERMAN:

Q. I'm asking you for the first time you asked it. If that hasn't been clear and you want to change any answer, please indicate that. A. I believe, to the best of my recollection, I would have asked him that question prior to that June wire.

Q. Do you have any feeling how long prior to that wire you would have first asked him that question, if it was a couple of days before or a month before? A. As I recall, it would have been months before.

Q. And yet subsequent to your July, 1978 progress report on Basic, Inc.? [1846] A. Would you give me that date again?

Q. January, 1978 progress report on Basic, Inc. A. I may even have asked him prior to that. I just can't recall the exact date, you know, of my first inquiry.

Q. The first time you asked Mr. Muller about any possible merger conversations with any company, what did he say? A. He indicated to me that they had experienced inquiries from companies interested in acquiring Basic, or, at least, engaging in exploratory talks.

Q. What did you say during that conversation when he said that? A. I listened. You know, that was a good answer.

Q. Did you say anything else or ask any other questions during that time, during that conversation? A. I can't recall any specific questions I would have asked at that time.

Q. Did you ask him for the names of those companies? A. He never offered me the names of any companies at the time.

Q. I asked whether you asked him for the names of any of those companies at that time, the first time you spoke with him on the subject. A. I don't believe I asked him for any names.

Q. Why not? [1847] A. I try not to compromise officials at companies.

(Witness and counsel consulting.)

BY MR. WACHTERMAN:

Q. Did you ask him any other thing about any of these companies, what fields they were in, anything like that? A. No.

Q. You asked for no further information about those companies, at that time, the first time you spoke with him about this? A. Not that I remember.

Q. Did he give you any other information or say anything else about the subject of possible mergers during the first time you spoke to him on the subject? A. I believe he expressed that every year, they have had, for several years, they have had inquiries.

Q. Did he say anything else in that conversation about these inquiries? A. Not that I can recall.

(Witness and counsel consulting.)

BY MR. WACHTERMAN:

Q. Did you ever have any further conversations with Mr. Muller about—excuse me. In that first conversation with Mr. Muller, did he say anything about the receptivity of Basic to possible acquisition or merger inquiries? A. No.

[1848] (Witness and counsel consulting.)

BY MR. WACHTERMAN:

Q. In that first conversation with Mr. Muller, did he give any indication of whether there was any particular inquiry that was being pursued? A. No, he did not that I can recall.

Q. Did you ever have any further conversations with Mr. Muller about possible acquisition or merger of Basic, Inc.? A. Yes.

Q. When did that occur? A. Over the subsequent period.

Q. Over what subsequent period? A. Subsequent to the first inquiry.

Q. How many such contacts did you have with Mr. Muller concerning possible acquisitions of Basic? A. I can't recall the exact number.

Q. More than a dozen? A. I certainly had more than a dozen contacts with him.

Q. Well, concerning this subject. A. I can't be specific, but it was a number of calls where I asked that question.

Q. More than half a dozen times when you asked that question? A. I believe it was more than a half a dozen times.

[1849] MR. FRANK: Over what period of time? You have now tried to identify the number of times and you said over half a dozen. Over what period of time do those more than half a dozen calls occur?

THE WITNESS: I don't know when the first call occurred.

MR. FAIRBANKS: Over what period of time, all those calls?

THE WITNESS: From the first call at some unknown date through the fall of 1978.

MR. FAIRBANKS: Was it your testimony that the first call could have been even in 1977?

THE WITNESS: It could have been.

(Witness and counsel consulting.)

BY MR. WACHTERMAN:

Q. Mr. Mayer, the number of calls, you are talking about, in response to my question I take it, any calls in which the subject of a possible merger or acquisition of Basic were discussed, regardless of who initiated the discussion about that subject?

Is that correct? Or, are you only mentioning those calls where you asked a question about that? A. I made many more calls than the—

(Witness and counsel consulting.)

THE WITNESS: Would you ask me the question one more [1850] time?

BY MR. WACHTERMAN:

Q. Yes. With respect to your testimony about the number of calls in which you discussed in any respect possible acquisitions or merger of Basic, Inc., I take it that that number of calls that you are referring to is the number in which you in any way had any discussion with Mr. Muller with respect to the possible acquisition or merger of Basic, Inc., not only those calls where you may have asked a question about the subject? A. I would say yes to that.

Q. Were there any calls in which you did not ask the question and the subject was discussed? A. Not that I would remember.

Q. In other words, the subject was only discussed in response to your questions? A. So far as I can determine and remember, yes.

Q. And you said that the time period ended in the fall of 1978. When in the fall did you cease to have conversations with Mr. Muller about a merger or acquisition with respect to Basic? A. There was an announcement as I remember or recall, a Monday, December the 18th. They didn't open the stock for trading because Combustion Engineering had bid for the company.

Q. And that's when the time period ended for you? [1851] A. Yes.

Q. When was the last time you had discussed that subject with him before the end of that time period? A. I can't remember exactly, but it was shortly before.

Q. Was it in December of 1978? A. I can't recall whether it was.

Q. Was it before Thanksgiving? A. I can't recall, you know, any specific date or month.

Q. What do you mean by shortly before the announcement then? A. Within two or three months I would have asked it.

Q. Did you initiate the call to Mr. Muller? A. Yes.

Q. What did you say during that conversation? A. I can't recall what I would have said during that conversation.

Q. Did you discuss with him the possibility that Basic might be merging with somebody? A. I would have asked and I'm trying to recollect what I said.

(Witness and counsel consulting.)

THE WITNESS: In such a call, I would ask a question about inquiries.

BY MR. WACHTERMAN:

Q. What if anything did Mr. Muller tell you?

[1852] MR. FAIRBANKS: For the record, are you speaking generally about these calls, or do you have a specific recollection of a call two or three months prior to December?

THE WITNESS: The only specific recollection of a call I have was a call in July.

MR. FAIRBANKS: And when you are talking about all these other calls, you are talking about a general recollection of a kind of conversation you had typically with Max Muller in the time period we mentioned before?

THE WITNESS: Yes.

MR. FAIRBANKS: But you have no specific recollection of any particular call other than the one in July?

THE WITNESS: That's true.

MR. FAIRBANKS: I'm sorry to interrupt, but I'm trying to get this clear in my own mind, too.

BY MR. WACHTERMAN:

Q. The call shortly before the December 20th announcement of the Basic-Combustion Engineering merger, you have a specific recollection that a call took place concerning the subject of a merger with Basic, or do you not? A. I don't have a specific recollection of a specific call other than—the most specific recollection I have was a call I made in July.

Q. Before we get into the most specific recollection, do you have a recollection of when the last contact you had [1853] with Mr. Muller was concerning a possible merger of Basic? A. Sometime subsequent to July.

Q. Sometime prior to December— A. Fifteenth.

Q. And within two or three months of December 15th? A. I would say so.

Q. You had a conversation at that time with Mr. Muller and that conversation included a discussion of the possibility of Basic merging? A. Yes, I believe so.

Q. Do you have any specific recollection of what took place during that conversation? A. Not at this time.

Q. Do you have any recollection—

(Witness and counsel consulting.)

MR. FRANK: You asked him whether he had discussions about the possibility of Basic merging. I'm not sure that's the way he's phrased that with respect to that.

BY MR. WACHTERMAN:

Q. Let me phrase it more broadly. When was the last conversation you had with Mr. Muller concerning the subject of Basic merging? A. The most recent, or the last? The last one would be after the merger announcement.

[1854] BY MR. WACHTERMAN:

Q. Mr. Mayer, when was the last time previous, prior to the announcement of a Basic merger with Combustion Engineering, when was the last time prior to that that you had any discussion with Mr. Muller concerning in any way the possibil-

ity that Basic might merge or be acquired by somebody?

A. Some—

Q. Of course, that would include in the phrase [1855] conversations or discussions, whether you asked any question on that subject or he asked any question or he gave any answer or you gave any answer on the subject. A. Sometime between July and December.

Q. Is this the conversation that you earlier testified you think occurred two to three months before December? A. Yes.

Q. Did you call him, or did he call you? A. I can't remember exactly.

Q. Did Mr. Muller ever call you on the telephone? A. Yes.

Q. What was the substance of this conversation that occurred sometime between July and December, probably two to three months before December, as you recall?

(Witness and counsel consulting.)

THE WITNESS: I can't remember the conversation specifically or exactly what was discussed in the conversation, but I believe that I asked, "Have there been any inquiries from companies interested in acquiring Basic?"

BY MR. WACHTERMAN:

Q. Do you recall anything that Mr. Muller said during that conversation? A. "There are always companies interested in Basic."

Q. Is that what he said? A. Yes. That's what I recall.

[1856] Q. Did he say anything else during that conversation? A. Not that I can recall.

(Witness and counsel consulting.)

BY MR. WACHTERMAN:

Q. In this conversation with Mr. Muller between July and December, did you ask him the name of any of those companies? A. No.

Q. Did he indicate in any way the names of any of those companies? A. Not in that conversation.

Q. Did he indicate in any way the status of any merger or acquisition negotiations? A. No.

Q. Did he say anything beyond the fact that there were companies interested, always companies interested in Basic? A. He indicated that if an announcement was required, one would be made.

Q. Did he say anything else during that conversation about the possibility that Basic might merge? A. Not that I can recall.

Q. Did you have any other conversations with Mr. Muller concerning in any way the possibility that Basic might merge or be acquired? A. Yes.

[1857] * * * * BY MR. WACHTERMAN:

Q. Did you ever have any other conversations with Mr. Muller in which you asked him about inquiries being made about Basic, Inc. and its merging or the possibility that Basic, Inc. might merge or be acquired? A. Yes.

Q. When was the one—when did that occur? A. Over an extended period of time.

Q. As you can recall the specific conversations, when did they occur? A. I can't recall any specific conversations.

Q. At all? A. Except for one specific conversation in July of 1978. * * * *

[1859] * * * * Q. And when was the third call? A. The third call was July 27th.

Q. Is there anything about the trading activity in Basic, Inc. during that time period which led you to make that call or calls? A. I believe that's why I initiated the call.

Q. Would you explain to me why you initiated the call? A. The trading activity in the stock, and I can't remember the specifics of the trading activity, looked unusual to me. And, I called and I asked whether they had any inquiries from companies interested in acquiring Basic.

Q. You spoke to Mr. Muller? A. Yes, I did.

Q. What did Mr. Muller say? A. He indicated that they had had inquiries.

(Witness and counsel consulting.)

BY MR. WACHTERMAN:

Q. Mr. Mayer, did he say anything else besides that they had had inquiries? A. I asked him like who.

Q. I thought you told me earlier that you never asked that question. A. That time, I did. That's why I have the specific [1860] recall. He answered.

Q. What did he say? A. He indicated three foreign companies and didn't identify them by name, and two domestic companies which he did identify by name.

Q. What were the names of the two domestic companies that he named? A. I believe he said Eaton and TRW.

Q. Did he say anything else during that conversation besides naming the companies that had made inquiries?

(Witness and counsel consulting.)

THE WITNESS: I had asked him another question. I indicated that there was a rumor around that the company was going to be acquired by a West German company and that the rumor had as its source a Washington attorney.

(Witness and counsel consulting.)

THE WITNESS: Who was a customer of Merrill Lynch.

BY MR. WACHTERMAN:

Q. What was the basis of your information about this rumor? A. Someone told me of the rumor.

Q. Who told you? A. My supervisor.

Q. What's his name? A. Joe Sener, Jr.

[1861] Q. S-e-n-o-r? A. S-e-n-e-r.

Q. When did Mr. Sener tell you this? A. It could have been sometime in June or early July. I can't remember exactly.

Q. What were the circumstances under which he told you this? A. It came up in conversation with him. He's my supervisor and I talk with him frequently, or fairly frequently.

Q. And what did he tell you about this rumor? A. That he had heard a rumor.

Q. Did he tell you where he had heard it? A. No, he did not.

Q. Did he name the West German company? A. No, he didn't tell me.

Q. Excuse me? A. No.

Q. Did he tell you who the D.C. attorney was? A. No.

Q. Did he tell you where he was a customer of Merrill Lynch? A. No.

Q. Did he tell you anything else about that other than what you have told us here today? [1862] A. Not that I can recall.

(Witness and counsel consulting.)

THE WITNESS: I want to make sure it's clear that I'm not entirely certain that Mr. Sener, you know, was the person who told me that. To the best of my recollection, he was the source of that rumor.

BY MR. WACHTERMAN:

Q. Did you ever hear that rumor or any information about the subject matter of the rumor from anywhere else? A. I heard rumors of Basic being acquired by a West German company prior to that and subsequent to that.

Q. When did you first hear rumors of a West German acquisition of Basic? A. Sometime either May or June.

Q. Who did you hear it from? A. I can't recall who I heard that from.

Q. What were the rumors you heard in May and June? A. That Basic was going to be acquired by a West German company who was a buyer or which was a buyer of their chemicals.

(Witness and counsel consulting.)

THE WITNESS: I also heard it subsequent to that date.

BY MR. WACHTERMAN:

Q. Who did you hear it from subsequent to that date? [1863] A. I can't recall specifically who I heard it from, but I believe in September or it could have been October, either September or October, I heard that a West German company was interested in acquiring Basic at \$40 a share.

Q. You have no recollection as to who you heard that rumor from? A. I can't recall at this time who I heard that from.

Q. Did you hear it from somebody at Legg Mason? A. It's conceivable that I might have heard it within the branch office system. But, I can't recall.

Q. Did you ever see anything about these rumors, any of these rumors, in writing? A. Not that I can recall.

Q. Did you ever hear any other rumors about Basic, Inc? A. Yes.

Q. What were they? A. Well, there was the Flintkote rumor which I was aware of the situation.

Q. Intimately. A. There were other rumors on several occasions. There was a rumor that Hepworth, an English-based company—

Q. How do you spell that? A. I don't know, but I believe it's H-e-p-w-o-r-t-h, which supposedly is in a related business or refractories, was [1864] interested in Basic, in acquiring them. I heard that also around the May-June period.

Q. Where did you hear that rumor from—May-June, 1978? A. 1978. I believe I heard that from a registered rep in Baltimore, Maryland.

Q. A Legg Mason registered rep? A. Yes.

Q. What was his name? A. Her name is Leslie Stoll. I don't know how to spell it.

Q. What were the circumstances under which you heard it from Leslie Stoll? A. I believe she initiated a call to me.

Q. Any other rumors about Basic? A. Yes. Subsequent to issuing my report on Basic in May of 1977, someone from a Legg Mason Pikesville office asked if I was aware that there

were rumors that Basic was to be acquired earlier in 1977 by Diamond Shamrock and Hanna Mining.

Q. And what did you say? A. I said no, I had not been aware of that.

Q. Is that the only place you ever heard that rumor from, from the Pikesville registered rep? A. I heard that rumor once again the early part of [1865] 1978, very early in the year, like perhaps January. I heard a rumor that Diamond Shamrock was interested in acquiring Basic, Incorporated.

Q. Where did you hear that from? A. I can't recall the source of that.

(Witness and counsel consulting.)

BY MR. WACHTERMAN:

Q. Who was the Pikesville Legg Mason rep who told you about the rumor about Diamond Shamrock and Hanna Mining? A. I can't recall.

Q. Any other rumors about Basic, Inc. that you are aware of? A. None that I can recall at this time.

Q. In your July telephone call to Mr. Muller, what if anything else did he say besides naming the two domestic companies and indicating that three unnamed companies had made inquiries to Basic about mergers or acquisitions? A. It was in that conversation where he indicated, in response to my indicating to him that I had heard a rumor about a possible takeover by a West German company and the rumor being started by a Washington lawyer, he responded—he didn't answer that question.

He responded something to the extent those darn lawyers. They always think they represent somebody. He said if I have any negotiations with any company, I can do it or [1866] they can do it directly, president to president.

Q. Did Mr. Muller say anything else to you during that telephone conversation?

(Witness and counsel consulting.)

THE WITNESS: I remember that he gave me the names of TRW and Eaton and three foreign companies as a result of my mentioning about the Washington attorney.

BY MR. WACHTERMAN:

Q. What else did Mr. Muller say, if anything, about these companies that had made inquiries about Basic acquisitions? A. I can't recall him giving me any additional information about these companies.

Q. Did Mr. Muller say anything else to you during that telephone conversation? A. Not that I can recall at this time.

MR. FAIRBANKS: May I ask a question?

MR. WACHTERMAN: Yes.

MR. FAIRBANKS: Did he give you any indication of when they had had inquiries from the three foreign companies and the two you named?

THE WITNESS: I believe he said in the past year, but he may have said 1978.

(Witness and counsel consulting.)

[1867] BY MR. WACHTERMAN:

Q. Mr. Mayer, why did you ask Mr. Muller for the names of the companies in light of your previous testimony about how that was not necessarily proper? A. I'm not sure that I asked him a question as such, you know, like give me the names.

(Witness and counsel consulting.)

THE WITNESS: If I've indicated that I did ask a specific question, then I believe I'm wrong. The information came out of him when he was angry about my asking him about a rumor. I really can't remember the specific details of how that exactly came out.

If—I think I asked—if I said that, I really don't know or believe that I did do that, or ask a question.

BY MR. WACHTERMAN:

Q. In your July 10th or 12th phone call with Mr. Muller, did he give you any information concerning the status of the inquiries from those companies that he said inquiries had been made from? A. No.

Q. Did he say anything else about those inquiries other than what you have told us? A. No, not that I can remember.

Q. Did you ever have any other conversations with Mr. Muller concerning inquiries about—inquiries from [1868] companies about merging with Basic or acquiring Basic or any other information about Basic merging or being acquired by some company? A. From the time I made my first call 'till December 15th, I asked that question whether there have been any inquiries on a number of occasions.

Q. Did you ever ask any other questions concerning the subject of Basic possibly merging or being acquired? A. Not beyond the general question I normally asked him.

Q. Which was? A. Have there been any inquiries from companies interested in acquiring you.

Q. So you never asked any other question beyond that question? A. To my knowledge, I have not asked any other question.

Q. What other information during these various inquiries that you made did Mr. Muller give you? A. I can't be specific, you know, as to other questions, but I would ask questions—

(Witness and counsel consulting.)

THE WITNESS: I'm speculating at this point.

BY MR. WACHTERMAN:

Q. Do you have any recollection of him ever giving [1869] you any information in response to your question or otherwise concerning the subject of inquiries being made, about Basic merging or about the subject of Basic being acquired or negotiating for acquisition? A. You mean specific information in the detail of the Eaton, TRW?

Q. Did he ever give you any information? A. In response to that, he would say yes, there have been inquiries. There are always companies interested in Basic.

Q. Is that the only response he would give to that question? A. As I recall, yes.

Q. Is the July 10th or 12th phone call the only time Mr. Muller ever named a company to you with respect to either inquiries being made about a Basic merger or the possibility of a Basic merger?

MR. FRANK: During what period of time?

BY MR. WACHTERMAN:

Q. The entire time period you were in contact with Mr. Muller prior to December 15th, 1978. A. Excluding Flintkote?

Q. Excluding Flintkote. A. To my recollection, that is the only time he gave me any information.

[1870] Q. The information you received from Mr. Muller in mid-July, 1978, wherein he indicated that there had been inquiries from several companies concerning possible mergers with Basic and in which he named two companies, TRW and Eaton and three unnamed foreign companies, did you ever pass any of that information along to anybody? A. I passed it along to the Legg Mason Wood Walker salesmen, I believe, at a sales meeting.

Q. When did that occur? A. Probably the Tuesday following the time I had my conversation with Mr. Muller.

Q. What did you say during that sales meeting? A. I can't remember the specifics, but I would have indicated that—

Q. Why don't you just tell me the substance of what you told them if you don't remember the words? A. That in a recent contact with the company, the management had indicated that they had had some inquiries from companies interested in acquiring them.

(Witness and counsel consulting.)

[1871] BY MR. WACHTERMAN:

Q. Did you say anything else to the Legg Mason personnel? A. I believe that I contacted the reps within the firm that I was aware had a continuing interest in Basic and passed the information on to them also.

Q. Well, before we leave the sales meeting in which you gave this information to all the registered reps who were listening, presumably, did you mention in that sales meeting the names of the companies that Mr. Muller had told you? A. I am not certain that I did. But I'm not certain that I didn't.

Q. Did you say anything during the sales meeting about the significance, if any, of this information? A. I don't recall whether I did.

Q. Do you have any further recollection of anything else you said at that sales meeting about Basic, Inc.? A. No, not at this date.

Q. Did you pass the information from Mr. Muller to anybody else besides the sales people? A. I am uncertain of this, but I believe I would have passed it on to brokers that I remembered had a big interest or a continuing interest in the stock.

Q. How many such brokers were there at this time?

(Witness and counsel consulting.)

[1872] THE WITNESS: Would you repeat that question?

BY MR. WACHTERMAN:

Q. How many such brokers were there who you recognized as having an interest in Basic, Inc. at that time? A. Can I list the names?

Q. You don't have to. Just tell me the number. A. I'm speculating at this point as to the people I would have contacted.

Q. Did you contact people other than at the sales meeting to give them this information from Mr. Muller? A. I believe so.

Q. Do you know who you contacted? A. I can't recall exactly who I contacted.

Q. Did you contact Norman Oremland? A. I believe so.

Q. Do you know of anybody else you contacted with this information? A. I believe I contacted Jake Pierce. I believe I contacted Will Romanoff. I believe I contacted—I contacted at least one person in the Baltimore office. I can't think of the name. Those are all the names I can think of at this time.

Q. These persons who you contacted, when in point of time did you contact them to pass along the information from Mr. Muller? [1873] A. Is there a way of finding out the dates of July the 10th and the 12th?

Q. I don't have a calendar. What do you mean by the dates? A. It all depends on whether I received the information late in the day and what my other work load was.

Q. Did you contact them before or after the sales meeting? A. I may have contacted them prior to the sales meeting.

Q. Did you contact them separately or in any way together? A. Separately.

Q. Who did you contact first? A. I have no way of knowing at this point.

Q. You have direct lines to Legg Mason branch offices? A. I go through the Baltimore switchboard in most cases.

Q. Is it a long distance call to Baltimore? A. No. It's a local, internal call. I dial the Baltimore operator and she places the call.

Q. What did you tell Mr. Oremland at this time concerning your discussion with Mr. Muller around July 10th or 12th? A. I don't remember the specifics of that conversation.

[1874] Q. You have no recollection of that conversation? A. No, no specifics.

Q. Do you remember what you told any of the other representatives about your conversation with Mr. Muller? A. I can't remember the specifics of those conversations.

Q. Do you remember the substance of what you told them? A. Yes.

Q. Do you remember the substance of what you told Mr. Oremland? A. Yes.

Q. What is the substance of what you told Mr. Oremland? A. That I had been in contact with the company and they had indicated that they had had, past tense—

Q. Did you emphasize past tense to Mr. Oremland? A. No. Inquiries from three foreign companies and two domestic companies and I believe I mentioned the names.

Q. The names TRW and Eaton? A. Yes.

Q. Did you say anything else to Mr. Oremland? A. Not that I can recall.

Q. Did you in any way relate those names or the fact that Basic had had inquiries with the current activity of the stock? A. I can't recall whether I did at this time.

[1875] Q. Did you ever discuss with Mr. Kiehne Basic, Inc.? A. Infrequent occasions.

Q. Did you ever discuss with him the fact that you believe it was an acquisition candidate? A. Yes.

Q. Did you ever discuss with him the name of any company that might be interested in acquiring Basic, Inc.? A. Mr. Kiehne would wind up getting—

(Witness and counsel confer.)

THE WITNESS: Yes.

BY MR. WACHTERMAN:

Q. During what time period was this? A. At any time when I passed the information on to registered reps either through the interoffice communication system or directly I would also be talking probably with Ernie Kiehne.

Q. Did you make to him TRW and Eaton? A. I don't remember specifically mentioning that to him but he was present at the sales meeting where I indicated that.

Q. Did you ever reveal to anybody your source of the information about TRW and Eaton? A. Yes.

Q. Who did you tell? A. Max Muller. I mentioned that at the sales meeting.

[1876] * * * * Do you have any other information which you can provide to the staff to substantiate the statements you've made regarding what Mr. Mueller said to you? A. No. Only my recollection that he said it.

Q. During one telephone conversation? A. In July.

Q. No other time? A. I don't believe it came up again.

Q. No one else was present? A. No.

Q. With respect to persons whom you told that information to and told the source of that information there has been prior testimony concerning that, and I just want to go over that with you. A. Yes.

Q. You did tell the sales meeting, the phone hookup subsequent to your phone conversation with Mr. Mueller, immediately subsequent, I think you said the next Tuesday after, whatever it was. A. I believe I told them as soon as possible.

Q. Correct. And you used the names Eaton, TRW and unnamed foreign corporations. A. Yes.

Q. Telling that phone hookup that information. A. Yes.

[1877] Q. And you told them that that source of information was the president of Basic. A. I believe so.

Q. Did you mention Mr. Mueller's name or did you just— A. I may have said "in a contact with Basic, Incorporated I learned this." I'm not sure I mentioned his name specifically, but I may have or I may not have. It's been so long that I can't recall now.

Q. And why did you tell in that phone hookup, to the sales hookup, why did you give them that information? A. Because it reinforced my original recommendation. It is an interesting, the company was an interesting acquisition candidate.

Q. And the fact that these named companies and unnamed companies had made acquisition— A. Confirmed my belief.

Q. And that's why you told it to them? A. Yes.

Q. Did you tell it to them in that context? A. I told it to them in the past tense, that Max Mueller had said that they had, he had been contacted in the past year.

Q. Did you tell it to them in the context of these inquiries confirming your belief that it was an acquisition candidate?

[1878] A. No. But that's the reason why I would tell them, that I had confirmed my belief.

Q. You said no. You say you are sure that you did not tell it to them in that context. A. I'm not a hundred percent sure of the conversation, other than that it occurred. As to the specifics, as to the tone of my voice, et cetera and all the details, finite details I do not remember.

Q. But that was your belief that's why you did tell it to him— A. Yes.

Q. —that you confirmed your belief that it was an— A. Yes.

Q. —acquisition candidate? With respect to the telephone sales meeting hookup that you had an addressed, did you ever mention the names TRW, Eaton Corporation or unnamed foreign corporations in connection with making inquiries about Basic at any subsequent time? A. Whether I made them at a subsequent telephone hookup I don't remember.

* * * *

**Excerpts from the deposition of Max Muller
by Respondents**

[49] * * * * Q. When do you first recall having any contact, or discussion is the word that keeps coming up in my mind, but any conversation with anyone at Combustion Engineering with respect to the possibility of a merger or acquisition or some form of combination of the two companies? A. Too many words. Is that a meeting, you say, or discussions or conversations?

Q. Conversation, whether face to face or on the telephone. A. I recall a visit to Cleveland and, to the best of my knowledge, a trip to one of our plants having taken place in or about 1966.

Q. Do you recall who from Combustion [50] Engineering was involved in those trips?

MR. MADSEN: He's referred to one trip, as I understand it, or visit to Cleveland.

Q. I'm sorry. I understand it to be— A. One visit. Maybe I phrased it poorly.

Q. All right. A. A visit by Mr. Kelly took place in or near 1966, which may have included a motor trip to one of our plants.

Q. Do you recall how that trip was arranged? A. I do not.

Q. Do you recall, did Combustion make the first contact or did Basic make the first contact? A. I recall that Combustion made the first contact.

Q. Was that contact with you personally? A. It was not with me.

Q. Was it with Mr. Bells? A. To the best of my recollection it was addressed to Mr. Bells.

Q. We're talking about Howard Bells now? A. Howard Bells, Jr.

Q. There is a second Mr. Bells, is there not? [51] A. There is a nephew.

Q. Just for clarity, is Samuel Bells, Jr. the nephew of Howard Bells, Jr.? A. Yes.

Q. And that's the defendant in this case, or that is one of the defendants in this case?

Samuel Bells, Jr. is a director of Basic, who is a defendant in this case?

MR. STERNMAN: Was a director.

Q. Was a director of Basic, who is a defendant in this case? A. Was a director. Correct.

Q. To the best of your recollection had there been meetings or conversations between Mr. Bells and someone at Combustion prior to this visit by Mr. Kelly, that you recall? A. I do not know. * * * *

Q. What was discussed during this visit of Mr. Kelly's? A. I do not know. * * * *

[81] * * * * Q. At the top it says, M.M.'s position, Basic is not for sale, but in the shareholders' interest we should listen.

What does that mean? A. That we should listen to a party or parties or agents for a party or parties expressing an interest in acquiring part or all of Basic or one of our divisions. * * * *

[92] * * * * Q. Do you recall any suggestion that Combustion Engineering might purchase Basic or a portion of Basic? A. Not beyond what I already stated.

Q. What you've already stated is that Mr. Kelly suggested that they were complimentary businesses and there might be a way of combining them, is that right? A. That's what I stated.

Q. The 1976 product line sales figures set forth in Plaintiff's Exhibit 5, are they public?

MR. MADSEN: You mean were they at the time of this letter?

Q. Were they at the time? A. No.

Q. Is that the reason that you asked Mr. [93] Kelly to keep the 1975 figures confidential? A. No.

Q. That's not the reason? A. No.

Q. Why did you ask Mr. Kelly to keep the 1975 figures confidential? A. We did not wish to have these figures fall into the hands of a competitor and disclose our activities in various areas.

Q. When you first discussed with Mr. Kelly the possibility of some form of combination of Combustion Engineering's refractories division and Basic, what did you say to him about his suggestion? A. To the best of my recollection I agreed that the two refractory businesses would be complimentary.

Q. And did you agree that some form of combination might be desirable? A. To the best of my recollection I agreed.

Q. Then that's why you entered into these discussions? Are you nodding yes? A. Yes. * * * *

[112] * * * * Q. Have you had a chance to review Plaintiff's Exhibit 13? A. Yes, I did.

Q. Does this help refresh your recollection as to whether or not Mr. Kelly made a visit to Cleveland on January 12th, 1977? A. It refreshes my memory that he was there during early January.

Q. You do recall the meeting that's described in this memorandum? A. I do.

Q. Do you recall Mr. Kelly stating that he was, quote, very interested in Basic Inc. as an acquisition, close quote?

MR. MADSEN: You're asking him independent of the document?

MR. CROSS: I am quoting from the document, but I'm asking him if he remembers Mr. Kelly expressing that he was [113] very interested in acquiring Basic.

A. I recall Mr. Kelly's expression of interest in the possible acquisition of Basic.

Q. Do you recall what your response was? A. I do not recall my response, no.

Q. Do you recall discussing with Mr. Kelly the fact that, without an acquisition of Basic, Combustion Engineering could not be an overall competitor of H & W, A. P. Greene, General and Kaiser? A. Yes, I recall that was mentioned.

Q. Did you agree that that was probably the practical effect of Combustion not being able to acquire Basic? A. Yes.

MR. MADSEN: You mean agreed in his own mind?

MR. CROSS: Well, in his own mind and to Kelly.

Q. Did you agree with Kelly's assessment of his competitive position? A. I did.

Q. What is H & W? A. It's the largest refractory company in the world. Harbison-Walker, Pittsburgh.

[114] Q. What is A. P.? A. A. P. Green, a subsidiary of U.S. Gypsum.

Q. And what is General? A. A large refractory company partially owned by Great Lakes Carbon.

Q. And partially owned by who else, do you know? A. I do not know.

Q. Is the name of the company General or General Refractories? A. General Refractories.

Q. And Kaiser, is that a company associated with Kaiser Industries? A. Yes.

Q. Are all four of those companies manufacturers of both basic and alumina based refractory materials? A. Yes.

Q. Do you recall discussing with Mr. Kelly the feasibility of Combustion Engineering entering the basic refractories market by starting from scratch? A. I do not recall that.

Q. Do you agree with his analysis that in 1977 it would not have been feasible for [115] Combustion to start from scratch, based on your knowledge of the market and financial conditions? * * * *

* * * * A. You used the word feasible.

Q. Economically feasible, as contrasted with possible? A. You're changing the question to economically feasible?

Q. Yes. Feasible from a business standpoint. I assume that it was possible, physically possible to build a plant, but the question is whether from a business perspective or economic perspective it was realistic, maybe that's the word, for Combustion to consider entering the refractories market from scratch? A. No, I do not recall agreeing to that in those terms.

Q. Do you recall Mr. Kelly expressing that view? [116] A. I don't recall that, no.

Q. What do you recall of the discussion with Mr. Kelly on January 12th, 1977 about the structure of Combustion Engineering and how Basic would fit into it should an acquisition be consummated? A. I recall that CE would consider Basic as an independent unit and respect its management and modus operandi.

MR. STERNMAN: Can I hear the question and answer back, please?

(Record read.)

Q. Do you recall who raised the question of the position of Basic should it become part of Combustion; did you raise it or did Mr. Kelly? A. To the best of my knowledge Mr. Kelly raised it.

Q. Do you recall any discussion about that topic, or about the nature of the autonomy, the nature of the control? A. Not beyond what I've answered to your previous question.

Q. Was there a discussion or was it simply a statement by Mr. Kelly, to the best of your [117] recollection? A. To the best of my recollection it was a statement.

Q. Was there any discussion at that point about your own role in Basic or in Combustion Engineering should there be an acquisition?

I'm talking January of 1977. A. Not to my knowledge.

Q. Was there any discussion of Mr. Ludwig's role? A. Not to my knowledge.

Q. Do you recall anything about how the meeting on January 12th, 1977 was set up? A. To the best of my knowledge I recall that it originated by a telephone call from Mr. Kelly to Cleveland.

Q. To you personally? A. To the best of my knowledge to me personally.

Q. Do you recall how far in advance of this meeting it was? A. No, I do not recall that.

Q. Prior to the date of this meeting had you or anyone at Basic caused any kind of antitrust review to be conducted with respect [118] to the possibility of an acquisition of Basic by Combustion Engineering? A. I do not recall.

Q. I note that in the October 18th letter of Mr. Kelly to you, which you responded to on November 1st, he was conducting an antitrust review.

Do you recall that you considered conducting such a review of your own?

MR. MADSEN: What is your question again?

MR. CROSS: I'm asking him whether or not sometime in the period after November 1, 1976 and prior to January, 1977 Mr. Muller considered conducting a parallel antitrust review.

A. I do not recall.

Q. Do you recall mentioning the subject of Mr. Kelly's interest to anyone on the Basic board of directors prior to this meeting of January 12th, aside from yourself and Mr. Ludwig, of course? A. I do not recollect. * * * *

[119] * * * * Q. Shortly following the meeting of January 12th did you discuss the topic raised at this meeting with the board of directors of Basic? A. I recall informing the board at the next regular board meeting of CE's interest in Basic.

Q. Is that the May 20th meeting that you've already testified about or would it be an earlier meeting? A. To the best of my knowledge it would have been at an earlier meeting.

Q. Do you recall, did the board of directors in 1977 have any regular meeting date; did they meet once a month? A. No. * * * *

[133] * * * * Q. Do you recall having the meeting on June 24th? A. I don't recall that.

Q. Did you ever go to Combustion Engineering in connection with the discussions between Combustion and Basic? A. I never did.

Q. Do you recall Mr. Kelly, sometime in the spring or summer of 1977, coming to Cleveland? A. Yes, I do.

Q. Do you recall what the discussion was on that occasion? * * * *

[134] * * * * A. I don't recall.

Q. Do you recall who attended the meeting? A. I do not recall who attended the meeting.

Q. Do you recall reporting the results of that meeting to anyone? A. No I do not recall reporting. * * * *

[147] * * * * Q. Did you ever discuss with Mr. Kelly his conversations with Mr. Mayr? A. Not to my knowledge.

Q. To your knowledge did Mr. Kelly ever mention Mr. Mayr's name to you? A. I don't recall.

Q. Directing your attention to Plaintiff's Exhibit 19, which is the more complete version of the first page of Plaintiff's Exhibit 20, do you recall how the October [148] 12th, 1977 meeting with Mr. Kelly was arranged? A. I do not recall.

Q. Do you recall who made the initial contact? A. No recollection.

Q. Do you recall having any discussion with Mr. Kelly regarding a possible acquisition of Basic by Combustion Engineering between the June 24th, 1977 meeting and this October 12th, 1977 meeting? A. No recollection.

Q. Where was the October 12, 1977 meeting? A. Somewhere in Cleveland.

Q. Was it in the Basic headquarters? A. I do not remember.

Q. Do you recall having any meetings with Mr. Kelly anyplace other than the Basic headquarters? A. Yes.

Q. Do you recall more than one meeting anyplace other than the Basic headquarters? A. To the best of my recollection, yes.

Q. There was more than one? A. Yes.

[152] MR: CROSS: Well, Mr. Muller wrote it, and Mr. Muller could hardly be ready to merge with Basic.

Q. Mr. Muller, is it your recollection that Mr. Kelly asked whether or not Basic was ready to merge with Combustion Engineering; regardless of what you wrote here, is that your recollection of what he asked? A. Yes.

Q. And was that a follow-up to the October 12th meeting or something that had happened between the October 12th meeting and November 10th? A. I cannot recall whether it was a follow-up. It was a question.

Q. Well, was the question are you, quote, ready to merge, is it your recollection that that was the subject of the October 12, 1977 meeting? A. I don't recall the October 12th meeting, where it went on.

Q. Do you recall anything more about this conversation with Mr. Kelly on November 10th? A. I do not.

Q. Your note here indicates you said not yet.

[156] * * * * A. Our office received numerous calls by brokerage firms in New York, Cleveland, perhaps others, that a rumor was rampant on Wall Street that Flintkote was about to make a tender offer for Basic shares at \$25.

A vice president of Flintkote and two mining engineers had been at our office a few weeks prior to this date to discuss the feasibility, desirability of a joint venture in the lime industry based on Flintkote's reserves and our knowledge on preparing burnt lime.

After having received numerous calls informing me of a rumor on Wall Street, I telephoned Mr. Waddel of Flintkote, the gentleman who had been in Cleveland with his geologists or with his mining engineers, and asked him point blank if Flintkote indeed were suiting up, preparing a tender offer.

He said absolutely not, this was not true, and he said we'd better take steps to clear the air, whereupon I suggested that we prepare a release to the Plain Dealer as quickly as we could and might also take it [157] over to the Wall Street Journal. Whether they printed it or not was another thing.

There was a period of perhaps a half a day which we used to prepare this document, and by we I include Messrs. Ludwig and Thomas and perhaps Collins, our director of public relations, but I do not recall what part each played.

I read this over the telephone to Mr. Waddel. I do not recall whether he suggested editorial changes which were in fact incorporated or not, but suffice it is to say that he approved the form in which the release was taken down to the Plain Dealer.

Q. When was the release taken down to the Plain Dealer? A. To the best of my knowledge one day prior to this article. * * * *

[173] * * * * Q. Mr. Muller, directing your attention back to the October 12th, 1977 meeting between yourself, Mr. Ludwig, Mr. Caito and Mr. Kelly, what if anything did you or one of the other Basic people say to Mr. Kelly in the course of that meeting about future course of discussions? A. To the best of my recollection we said absolutely nothing. We were totally passive and left that up to Mr. Kelly.

Q. What if anything did you say to Mr. Kelly or did Mr. Kelly say to you in the course of that meeting that made it appropriate for him to say on November 10th are you ready to merge? * * * *

[174] * * * * A. Nothing at all that I remember.

Q. Well, did you find that an unusual statement or a statement out of context by him on November 10? A. I interpreted it more in jest, that it was said in jest more than anything else, based on the previous contact we had whereby we were, we, Basic people, were extremely passive and listened atentively and politely but offered no comments or no suggestions. * * * *

[184] * * * * Q. Mr. Muller, in connection with the preparation of this written statement did you discuss with counsel the discussions that you had had with Combustion Engineering with respect to the possibility of an acquisition? A. To the best of my recollection I did not, because we were focusing on a specific occurrence, i.e., the widespread rumors of Flintkote taking over Basic, and we did not [185] in any way discuss Combustion Engineering at that time. * * * *

[196] * * * * Q. Mr. Muller, by submitting the statement to the Cleveland Plain Dealer did you intend to deny that there were any negotiations with Combustion Engineering?

MR. STERNMAN: You said specifically the first time.

Q. Did you specifically intend to deny that there were any negotiations with Combustion Engineering for a merger? A. No. * * * *

[198] * * * * president Max Muller said in what you wrote and submitted to the Cleveland Plain Dealer? A. To the best of my recollection my name was in the type on the typed sheet that we had taken down.

Q. Prior to submitting the statement, the written statement to the Cleveland Plain Dealer, did you discuss or review the statement with any member of the board of directors at Basic, other than Mr. Rose and Mr. Ludwig? A. Not to my recollection.

Q. Did you discuss it with Mr. Caito? A. I don't remember.

Q. Do you recall discussing the text or substance of the Cleveland Plain Dealer article with any member of the board of directors following the publication of the article? A. I do not remember.

Q. Did the topic come up at the board meetings?

MR. MADSEN: By topic do you mean the text of this article?

MR. CROSS: Or the [199] substance of the article. I'm not asking merely did they review the precise language of it, but did they review the substance of the article at a board meeting.

A. Yes.

Q. It was reviewed? A. Yes.

Q. Do you recall what board meeting? A. I do not recall.

Q. Do you recall if it was the article itself that you discussed or the trading activity and the Flintkote rumors? A. To the best of my recollection I related the telephone calls giving us, Basic, the rumors related the events that led up to this, the numerous rumors, and the steps we had taken to clarify the situation as mutually agreed upon between Flintkote and ourselves.

Q. Do you recall what board meeting that was at? A. I do not recall what board meeting that was at. * * * *

[226] * * * * Q. Was it around this time, around January 30th, 1978? A. To the best of my knowledge it was late 1977, I think, but I am not sure.

Q. What was the purpose in initiating contact with Kidder Peabody? A. To consider by us commissioning Kidder Peabody to embark upon an evaluation of Basic Incorporated.

Q. Was this your first contact with Kidder Peabody?

MR. MADSEN: You're asking him personally?

Q. Was this Basic's first contact with Kidder Peabody? A. Kidder Peabody has a representative in Cleveland with whom I had some very slight contact, nonprofessional contact.

Q. But you had not been regularly using Kidder Peabody for investment banking or financial advice prior to this time we're talking about now? A. Correct.

[232] * * * * Q. At what point in 1977 did the topic of or the possibility of acquiring Combustion Engineering's refractories division arise? A. My recollection is that this decision was arrived at late October, early November, in 1977.

Q. When you say decision, was this a decision in Basic? A. Decision among Messrs. Caito, Ludwig and myself.

Q. When you say a decision, was it a decision to acquire or a decision to consider acquiring the refractories division? [233] A. Management is not empowered to make decisions of that kind. That is a matter of the board. We made the decision to approach and negotiate for the division subject to board approval. * * * *

Q. Do you recall discussing that possibility with Mr. Kelly at the October 12, 1977 meeting in Cleveland between Mr. Kelly and yourself and Mr. Ludwig? A. I cannot recall the date, but I recall very vividly that Mr. Ludwig and I, without the presence of Mr. Caito, approached Mr. Kelly on our concept of acquiring CE's refractories division.

[243] * * * * Q. Do you know how long it had been since you'd spoken with Mr. Kelly before that phone call? A. At least three months or four. Three or four months.

Q. Your recollection is that you hadn't talked to him since the October meeting? A. No. I think there was a phone call in November, and after that time there was no contact with Mr. Kelly or anyone from CE until I suggested that he would meet with us.

Q. What was the purpose of the meeting that you set up? A. The purpose of the meeting was to propose to him that Basic would like to acquire CE's refractories division. * * * *

[247] * * * * Q. Did the meeting on February 27th at Burke Lakefront Airport take place? A. Yes, it did.

Q. Who attended it? A. I recall that Messrs. Ludwig and I met with Kelly.

Q. And what did you describe to Mr. Kelly? A. To the best of my recollection I expressed our belief that the long period of [248] silence by CE indicated loss of interest on their part in our company; that I held to the belief that the two divisions should be joined to form a stronger unit and, therefore, we had discussed this among Caito, Ludwig and I and wanted to approach CE for Basic to purchase the refractories and perhaps the minerals division.

Q. And what did he say? A. He seemed agreeable, seem amenable to the idea, but he would furnish us financial information. He was quite firm about the minerals division being really not germane and thought he would rather just talk about the refractories division and for the present time exclude the minerals division from any consideration of their selling that unit to Basic. * * * *

[254] * * * * Q. Thank you. At the meeting on February 27th, 1978 did you and Mr. Kelly discuss further Mr. Kelly's interest in acquiring Basic? A. Not to my knowledge. * * * *

[255] Q. As I understand it, Mr. Muller, you proposed the purchase of CE's refractories division, and what I'm asking now is, in the course of the meeting did the topic of Mr. Kelly's interest in purchasing Basic come up? A. I do not recall.

Q. Did you agree on a next step at that meeting? A. Yes.

Q. What was the next step? A. For CE to provide financial figures on CE's refractories division. Mr. Kelly volunteered to have Mr. Insley, the financial vice president of his division, come to Cleveland to explain and work with us on our evaluation of the refractories division. * * * *

[343] Q. Do you recall discussing the substance of Mr. Thomas' and Mr. Ludwig's conversation with Morgan Stanley with them when they got back? A. Yes, I do.

Q. Do you recall that they discussed with Morgan Stanley the fact that Morgan Stanley had a client that was analyzing Basic? A. I do not recall that.

Q. And it's your testimony that neither Mr. Ludwig nor Mr. Thomas discussed Combustion with either Kidder Peabody or Morgan Stanley on November 9th? A. Emphatically, yes.

Q. Did there come a time when you met with anybody from Kidder Peabody? A. Yes.

Q. Do you recall when that was? A. No.

Q. Was it in 1977? A. I do not recall the date.

Q. Do you recall, in any of your discussions with Kidder Peabody, and I'll start by limiting it to during 1977, discussing Combustion with Kidder Peabody? [344] A. No.

Q. Did you ever discuss Combustion with Kidder Peabody prior to December 1978? A. Yes.

Q. When was the first time you recall discussing Combustion with Kidder Peabody? A. To the best of my recollection, it was December 14th or 15th.

Q. 1978? A. 1978. * * * *

[345] * * * * A. I presume, Mr. Cross, you mean when I recall the first discussion with Kidder Peabody, not the first time I recalled?

Q. Yes. I'm looking for the date. I'm looking for your recollection of the first date that you discussed Combustion with Kidder Peabody. A. I understood the question to mean that. To the best of my knowledge, the first time I talked to Kidder Peabody about Combustion Engineering specifically was either December 14th or 15th.

MR. MADSEN: Of what year?

THE WITNESS: 1978.

Q. Do you know whether anyone else at Basic discussed Combustion specifically with Kidder Peabody prior to that time? A. To my knowledge, no one did.

Q. Does that mean you're not aware of anyone doing it, or were there instructions given that no one should?

MR. MADSEN: Object to the form of the question.

A. Instructions is a wrong word here. There [346] was agreement that we would not mention any company name specifically to Kidder Peabody or Morgan Stanley or anybody else.

Q. That's on November 9th, 1977. I understand that. But thereafter? A. Thereafter also. * * * *

[347] * * * * Q. You testified that on November 9th the question of unexpected tender offers was one of the items discussed with Mr. Siegel of Kidder Peabody by Mr. Ludwig, is that right; the possibility of an unexpected tender offer was one of the topics, is that right? A. Yes.

Q. What I'm asking is, leaving aside the generalized possibility of an unexpected tender offer, when do you recall anyone at Basic discussing with Kidder Peabody a specific possibility for a merger or acquisition involving Basic; even though you [348] may not have mentioned the name of the company you had in mind because you had an agreement not to mention that name, when do you first recall doing that? A. To the best of my recollection, we discussed such a possibility during Mr. Siegal's first visit to Cleveland, where he explained that in many cases the result of an uninvited, unwanted tender was the purchase by someone else of the shares of the company, as witnessed by X Y Z, and he named some examples, the names I do not recall.

Q. Did he describe that as being a so-called white knight; did he use the phrase white knight? A. I believe that term was used in that meaning. It's a very common term, as I later found out.

Q. But the concept he was discussing with you was the concept of a friendly takeover as part of a strategy to defeat an unfriendly takeover, is that correct? A. Yes. * * * *

[355] letter from Kidder Peabody, which you signed on March 14, 1978, according to the date that it bears, is it your recollection that your first meeting with Mr. Siegal was before or after you signed what is Plaintiff's Exhibit 73? A. My recollection is that it was before this.

Q. You met with him before March 14th? A. Yes.

Q. You didn't sign it during that meeting?

MR. STERNMAN: During what meeting?

MR. CROSS: The first meeting with Mr. Siegal.

A. I don't recall. My recollection is that the first meeting between Mr. Siegal and us was prior to this March 14th.

Q. Do you have any recollection of why the date November 16th, 1977 is singled out by Kidder Peabody as being the commencement of their retainer? A. I don't.

Q. Do you recall the circumstances under which Kidder Peabody visited you?

[356] MR. MADSEN: You're talking about the first visit?

MR. CROSS: Yes. Let me clarify that.

Q. Is it possible that the first meeting with Kidder Peabody was November 16th, which was the week after there had been a discussion in New York with them?

MR. MADSEN: Object to the form of the question, use of the word possible.

A. It's possible.

Q. Well, I'm asking whether this document helps refresh your recollection as to the fact that the first meeting with Kidder Peabody may have, in fact, been substantially before the Burke Lakefront meeting with Mr. Kelly? A. This does not refresh my recollection, but I recall that Kidder Peabody performed work on a verbal commission, and I recall that this was a formalization, a written confirmation of a verbal commission. * * * *

[358] * * * * Q. Mr. Muller, the way I read that, the oral retention just described to us in your last answer was on or about November 16, 1977.

Do you recall any discussions with anyone at Basic that Kidder Peabody had, in fact, been signed on sometime shortly after the first contact with him in November? A. Yes. I recall that Kidder Peabody was given a verbal assignment and was commissioned to commence to work for us.

Q. Shortly after the November 9, 1977 meeting? A. I do not know when that happened.

[361] * * * * Q. Do you recall telling Mr. Freedman during that call that you had already established a relationship with Martin Siegal at Kidder Peabody? A. Yes.

Q. Do you recall how you became aware of the fact that you had established a relationship with Martin Siegal, if you'd never spoken to him?

Did Mr. Ludwig tell you? A. It would have been Mr. Ludwig who told me that he was impressed with the Kidder Peabody organization and had recommended that we enter into an agreement.

Q. Well, do you recall having such a conversation? A. No, I don't. * * * *

[362] * * * * Q. Now, my question is, what was the verbal commission; what were they supposed to do? A. It is my recollection that they were to start an evaluation of Basic.

Q. Basic as a company or Basic's securities or both? A. Basic as a company, divided by the number of shares and preferred shares, i.e. both.

Q. Were they to come up with a value for Basic's stock, a fair value for Basic's stock, [363] independent of market value?

MR. MADSEN: Object to the form of the question.

Q. Was that part of their commission?

Let me rephrase the question, Mr. Muller. A. All right.

Q. Was Kidder Peabody asked to develop a report or give an expression of their opinion as to the value of Basic's securities, without reference to the market value, in the sense of what the New York Stock Exchange was quoting the stock as?

I only say that because I assume you could read that in the Wall Street Journal.

Were they asked to give you an opinion as to the value of Basic's securities? A. I was not present when the commission was given. Mr. Ludwig made the assignment. It was my impression that Mr. Ludwig was to commission them to make an analyses of the value of our company, of the shares, securities, independent from what the street traded our shares.

Q. Do you recall ever receiving such an evaluation of Basic's securities from Kidder [364] Peabody? A. Yes, I do.

Q. Do you recall when you received such an evaluation? A. A few days before or after December 20th, 1978.

THE WITNESS: Let me ask for a minute recess. I'll be right back.

MR. MADSEN: Sure.

(Recess had.)

BY MR. CROSS:

Q. Mr. Muller, prior to December of 1978, did you ever receive any kind of evaluation of Basic's securities from Kidder Peabody? A. Not to my knowledge.

Q. Either written or oral? A. Not to my knowledge. * * * *

[367] * * * * Q. Did you ever get anything in writing from Kidder Peabody, other than these various retainer letters which we've been showing you? A. Not to my knowledge.

Q. No kind of report at all?

MR. STERNMAN: Prior to December of 1978?

MR. CROSS: Prior to December of 1978.

A. Not to my knowledge.

Q. Did you have any further meetings with Mr. Siegal or anyone else from Kidder Peabody after the first meeting that you've described?

MR. MADSEN: Prior to December of 1978?

MR. CROSS: Prior to December of 1978.

A. Yes.

Q. Do you recall when and where? A. I do not recall when, I recall where.

Q. Where? A. At Basic's office, with Mr. Parker and his assistant or assistants.

Q. Do you recall how long after the first [368] meeting that was? A. I do not recall that.

Q. Were you at that meeting? A. In and out.

Q. How long did the meeting take place; how long was the meeting? A. To my recollection, the meeting took the better part of the day.

Q. How long after the first meeting with Mr. Siegal was that meeting? A. I do not recall.

Q. Was it a matter of weeks? A. I don't know.

Q. What was the topic of that meeting? A. You mean the purpose?

Q. The purpose. A. The purpose was to render Mr. Parker and his staff knowledgeable about Basic's business, respond to their questions, and furnish them such financial information as they deemed necessary for their evaluation, for their work. * * * *

[435] * * * * Q. With whom did you discuss? A. Mr. Rose, but in his capacity as counsel and not as a director of the company.

Q. Do you recall any other discussions with directors of the company?

MR. MADSEN: Object to the form of the question.

A. Yes.

Q. With whom? A. Casual conversations with Messrs. Ludwig and Caito, with the inside directors.

Q. Any of the outside directors? A. Not to my recollection.

Q. What about Mr. Wilson? A. I don't recall any.

Q. Let me show you a document that was produced by Mr. Wilson as Wilson 1 and have it marked as Plaintiff's Exhibit 85. It's headed Max ph 6/28/77.

(Muller Deposition Exhibit 85 was mark'd for purposes of identification.)

[436] Q. Do you recall, Mr. Muller, such a conversation on or about June 28, 1977? A. I do not recall such a conversation.

Q. Do you have any recollection as to what the figure 500,000,000 out on the right-hand side of that document would mean or does mean?

Does that figure mean anything to you? A. I'm searching. I'm trying to interpret the BP. It's obviously not his salary.

Q. I'll quit practicing law if it is.

Do you recall calling Mr. Wilson at any time? A. Yes.

Q. Where does Mr. Wilson live? A. Milwaukee. * * * *

[437] * * * * A. No. At his office, yes.

Q. Well, at his office? A. Yes.

Q. Do you recall describing to Mr. Wilson a merger offer for Basic? A. I don't recall it.

Q. Do you recall any discussion with him about a conflict of interest? A. No, I don't recall it. This puzzles me here.

Q. Do you recall discussing Combustion Engineering with Mr. Wilson at any time, outside the context of a board of directors meeting? A. I don't recall it.

Q. Let me show you a document— A. I'm sorry. I cannot find an explanation for the 500,000,000.

Q. Well, can you find an explanation for any part of this document? [438] A. Yes. Jim Kelly, V.P. is obviously vice president. Ladle brick is one of the lines of products of Combustion Engineering's refractories division. Alumina brick

is one of their lines. Friendly interest, that had been mentioned from time to time at the board.

Merger offer for Basic, conflict of interest, I cannot interpret what the writer meant by putting that down.

Q. What business is Mr. Wilson in? A. He is president and chief executive of a company that manufactures automated and mechanical welding equipment for automotive assembly lines, his customers being Ford, General Motors, Chrysler and so forth.

Q. What is the name of his company? A. Acro Welding, Milwaukee. * * * *

[444] MR. CROSS: Rose-1 is 86 and Ludwig-1 is 87. They are entitled recent interest in Basic, and the second page of each bears the date 1/10/77.

(Muller Deposition Exhibits 86 and 87 were mark'd for purposes of identification.)

BY MR. CROSS:

Q. Mr. Muller, look at Plaintiff's Exhibit 86 and tell me, first of all, whether you recall authoring that document? A. Yes.

Q. Do you recall authoring it on or about the date that it bears on page two? A. Yes.

Q. It says up at the top HCR something or other. Can you read what that says? A. Cleveland.

Q. CC given to MJL? A. Copy to Ludwig.

Q. That is your handwriting? A. It is.

[445] Q. Do you recall the circumstances under which you prepared this document? A. It was, either in preparation of a board meeting or as a result of a board meeting, distributed to each member of the board.

Q. To the best of your recollection, this document was distributed to each member of the board? A. Correct.

Q. The statement at the top of this document, "MM's position: Basic is not for sale, but in the shareholders' interest we should listen," was that a recommendation by you or your personal position, if there is a distinction between those two? * * * * A. It was both. * * * *

[455] * * * * Q. Do you recall setting some sort of time schedule or plan for pursuing the idea of acquiring Combustion's refractories division? A. I recall our decision to gear up to study feasibility, compare what financial information we needed. I do not know whether this all occurred at this meeting or not, but I remember distinctly that we discussed setting the machine in motion, because it seemed that Mr. Kelly was receptive to the idea.

Q. Did Mr. Kelly, at the February 27th [456] meeting, bring up the subject of Combustion buying Basic? A. Not to my knowledge. * * * *

[462] * * * * Q. You did make a proposal on June 7th, 1978, didn't you? A. Yes.

Q. And that's the only occasion when you made a formal proposal with respect to CE refractories? A. This was not a formal proposal, this was our first figure that we threw out.

Q. But it was the only figure you ever threw out? A. It was the only figure we ever threw out, but it wasn't any form of proposal at all. It was merely an overture to negotiations.

Q. Which Kelly rejected, in effect; he said [463] he wanted stock, not cash? A. I do not recall whether he expressed his preference. He might have. I do not know. But the distinct meaning that I read into his answer and that I put down here was that he felt the evaluation was too low.

Q. Your evaluation of CE refractories? A. Our evaluation of CE refractories. * * * *

[478] * * * * Q. Is it your testimony that Kelly didn't offer \$28 on June 7th? A. It's my testimony that this was a feeler, that he expressed it as such, what would you think to such a

figure, and with my shorthand I put down offer, which is totally wrong. * * * *

Q. I see. Kelly did suggest that \$28 a share would be an appropriate price for Combustion to purchase Basic at the June 7th meeting, didn't he? * * * * A. I do not recall how he phrased it.

Q. How about indicated? A. He indicated that that might be a figure that he would be willing to recommend to his management.

Q. And what did you say? A. Too low.

[481] * * * * Q. Did you open the meeting with your proposal for CE refractories? A. That is my recollection, after the usual amenities of the day.

Q. And what was Kelly's response, if you can recall?

Don't look at your memory crutch. A. Okay. My recollection is that he felt this was not giving sufficient recognition to the value of the refractories division, that he would not recommend to his company to accept a figure of that order.

Q. \$26,000,000? A. Yes.

Q. Did he suggest that you come back with a different figure? A. He did not suggest we come back with a different figure.

[482] Q. Did you suggest that you would come back with a different figure? A. We expressed our desire to continue our pursuit and negotiations.

Q. Did he express a willingness to continue? A. No. My recollection is that he concluded the meeting by saying, well, we still have an interest in acquiring Basic and threw out a feel of \$28. * * * *

[483] * * * * Q. Did Kelly indicate that he was receptive to continuing the negotiations for the purchase of the CE refractories? A. It appeared to us that he had not turned it down, but it became obvious that he guided the conversation to a suggestion that Combustion might still be interested in acquiring Basic, and then he came out with a feeler of \$28. * * * *

[486] * * * * BY MR. CROSS:

Q. What did you mean when you said, "Hold off until we tell you"? A. To the best of my knowledge, we had engaged Kidder Peabody to assist us in evaluating our worth. I did not wish for any company to come forth with some offer until we, Basic, had a better understanding of the value that our shares would be to someone else.

Q. Well, why did you adopt that approach?

I mean, Kelly was, in effect, saying, I'll make you a better offer, wasn't he? Isn't that the substance of what you've got recorded on your memory crutch?

MR. MADSEN: Object to the form of the question.

A. He didn't say that he was going to make a better offer.

Q. Well, didn't he suggest that he'd come to you with, quote, their best figure? A. He suggested that.

Q. And you're saying that you suggested to [487] him that he ought to hold off making any such offer.

Why did Basic's management want to adopt that sort of deliberate approach? * * * * A. First of all, if I can be quoted as being the author of the conversation, I had not given up the pursuit to purchase the refractories division, and a formal offer by Combustion would, in my opinion, seriously thwart or make it more difficult to achieve that goal.

Secondly, Kidder Peabody was engaged in evaluation because the \$26,000,000, if perhaps presented in part Basic shares or other forms, might look more attractive to Combustion Engineering.

Q. But you came away from the June 7th meeting with the impression that Kelly was prepared to make you an offer, didn't you, if [488] you wanted to receive the offer? A. Yes.

Q. And you didn't want to receive the offer for the reasons you've stated? A. Correct.

Q. Did you tell Mr. Kelly your reasons for telling him to

hold off making an offer or did you just tell him to hold off? A. I do not recall whether I did or didn't.

Q. Did you agree to get back to Mr. Kelly at some time in the future with respect to whether Basic would be receptive to an offer? A. I cannot recall any such statement.

MR. STERNMAN: May I have the last question and answer, please?

(Record read.)

Q. Following the June 7th meeting, did you have any contact with Kidder Peabody with respect to getting the evaluation that you'd been waiting for and that you said was one of your reasons for asking Kelly to hold off making an offer? A. I had no contact with Kidder Peabody.

Q. Did anyone at Basic? A. It was my impression that Mr. Ludwig's [489] department was in contact with Kidder Peabody to continue the work on development of the appraisal by Kidder Peabody.

Q. Am I correct that your testimony earlier this afternoon was that, following the June 7th meeting, you never made another proposal to Mr. Kelly with respect to purchasing CE's refractories division? A. That is correct. * * * *

[491] * * * * Q. Mr. Muller, was there, in your mind, some harm to be suffered by Basic if Basic had received a formal offer of Combustion Engineering's best figure prior to the completion of the Kidder Peabody evaluation? A. Yes.

Q. What was that harm, in your mind? A. Any offer would call for a speedy response and reaction. Without having in hand some expert opinion on the assessed value, assessed by financial experts, of our shares, an intelligent and speedy response would not be an intelligent one, or not an authoritative one, and would have to be evasive, delaying.

[492] This is the possible danger that I saw in an offer forthcoming prior to having in hand a solid document, a solid appraisal by a reliable firm.

Q. Following the June 7th meeting, did you do anything to accelerate Kidder Peabody's evaluation? A. I do not recall, but there was a constant effort on our part to have Kidder Peabody conclude their work or at least bring it to some point where we could sit down and have their preliminary opinion.

Q. Did you tell that to Mr. Kelly? A. Not to my knowledge.

Q. Did you tell Mr. Kelly that you wanted to wait for the Kidder Peabody opinion? A. I did not tell Mr. Kelly that.

Q. Did you tell Mr. Kelly that Kidder Peabody was evaluating Basic? A. At one time I informed him that we had engaged Kidder Peabody to assist us in evaluation of possible offers. * * * *

[499] Q. Then what did Kidder Peabody have to do with it; what were they going to do for you that would aid you in making a decision about whether or not Combustion Engineering's best figure was a good figure or an acceptable figure? A. They've had years and years of experience in this field. They have developed a feel for pricing of a merger, whereas I certainly had none. So their experience should take precedent over any judgment that we could make in-house.

Q. This commission that Mr. Ludwig gave Kidder Peabody starting back in November of 1977, and it kept getting renewed, according to what you just said, was that commission to arrive at a figure, an acceptable merger price figure for Basic? A. That was one of the assignments, among others.

Q. Is that your full answer? A. Yes. * * * *

[523] * * * * Q. You were asking Mr. Kelly for Combustion Engineering's product lines, or you were giving Mr. Kelly Basic's sales by product line? A. To the best of my recollection, I was asking for information from Mr. Kelly.

Q. What was the purpose of that information? A. The purpose of the request was to enable us to have Jones, Day make an antitrust study of what the Federal Trade reaction

might be if we were to purchase the CE refractories division. * * * *

[525] * * * * Q. Did you discuss with Mr. Kelly on June 20th, 1978 getting Combustion Engineering's "best" offer, informally? A. To the best of my knowledge, I did not discuss that.

Q. Why didn't you discuss that on June 20th? A. Because we had not reached any conclusion on how to react. * * * *

* * * * A. We had not reached any conclusion on the advisability. We had long discussions on [526] problems that might be associated with eliciting an offer, such as unrest within our own employees, such as customer reaction, which we had tested earlier, such as the business decision or the weighing of remaining independent, in view of our good prospects, where an increased earnings record might reflect very, very favorably on the price of our shares.

We had been reducing our debt to equity ratio. That was weighed.

We had not had an opportunity to discuss with Kidder Peabody, elicit their opinion, and counsel had advised us that we need not respond to Kelly's June 7th suggestion until we had weighed all the facts and had reached what at that time would have seemed a sound business decision. * * * *

[533] MR. MADSEN: No. Mr. Cross is asking you about what your understanding was of what Mr. Kelly said.

A. My understanding was that he had commissioned the CE lawyers quite some time ago to make that study.

Q. When quite some time ago? A. I have no idea.

Q. Wasn't it your understanding that he'd commissioned the CE layers to study the implications of Combustion Engineering acquiring Basic? A. Yes.

Q. And only that? A. Yes.

Q. Mr. Kelly never really had any interest in selling his refractories division, did he, in your mind? A. Yes, he did.

Q. He was interested? A. Yes. He listened very carefully.

Q. I understand he listened very carefully. * * * *

[546] Q. Who outlined this plan; was this a recommendation by any one person or was this a consensus? A. It was the result of a lengthy meeting between four people.

Q. Item A on Plaintiff's Exhibit 20B says, for the June 16th meeting, "Bring Kidder Peabody in on an evaluation."

What was Kidder Peabody going to be brought in to evaluate? A. To the best of my recollection, the first assignment would be the original assignment, the value of Basic's stock.

Q. Are we still talking about the value of Basic's stock in the way we talked about it yesterday, and that is, Basic's stock was valued as a stock to be acquired by someone as opposed to the intrinsic value of Basic as a company? A. Yes. Or to be used as payment for an acquisition. The reason for— * * * *

[560] * * * * Q. The two refractories divisions ended up being together, regardless of the form of the transaction, didn't they? A. I know. But there have been instances where a huge company would not add to one of their smaller divisions because they were able to do it themselves. However, the concept would be the same.

Q. Are you testifying that you decided to tell Mr. Steinhouse to only study the possibility of Basic acquiring the CE refractories division and not vice versa? A. I did not.

Q. I didn't think you were. * * * *

Q. Did your decision at this meeting to have Mr. Steinhouse look at, quote, CE versus Basic include a decision to have him look at [561] the possibility of Basic being acquired by Combustion? A. Yes.

Q. What is the reference to USG? A. Same assignment to Steinbrink, except this time the refractories division of USG.

Q. Were you considering buying the refractories division of USG? A. No.

Q. You never considered that? A. Never considered that.

Q. So that was strictly a consideration of USG buying Basic, the possibility of USG buying Basic? A. Yes.

Q. And Mr. Steinhouse's assignment with respect to USG was the same as his assignment with respect to CE? A. No.

Q. It was different.

How was it different? A. His assignment to CE was both-wise, the implications of Basic buying the CE refractories division, the implications of CE buying all of Basic.

[586] Q. You didn't tell him to hold off making an offer? A. No, I did not.

Q. Now, the next thing it says here is, "Advised against public disclosure."

Who said that? A. To the best of my recollection, it was Mr. Kelly who said that.

Q. Mr. Kelly said to you that he didn't think it was advisable for you to make any kind of public disclosure of the fact that he was going to prepare an offer? A. Correct. * * * *

[590] * * * * Q. Did you discuss the appropriateness of revealing your conversation with Mr. Kelly to the board?

A. The discussion was seeking legal advice. In that context, I discussed it with Mr. Rose.

Q. You discussed whether or not you should disclose it to the board? A. I inquired.

Q. And what did he say? A. He said, there's nothing formal, no need to tell the board yet.

Q. Did you specifically discuss with Mr. Rose the appropriateness of making any kind of public disclosure, specifically? A. I do not recall whether I did or didn't. * * * *

[598] is for July 13, 1978. It indicates that Mr. Kelly called. It says, "Kelly called: He will meet with First Boston on 7/14 re Basic."

Can you amplify on what Mr. Kelly said during that telephone call? A. I recall at one time Mr. Kelly told me that First Boston—

MR. MADSEN: No. He is asking about you—

THE WITNESS: What went on here. Sorry.

MR. MADSEN: Would you reread the question, please?

(Record read.)

A. It is my recollection that he told me that he would look to First Boston to assist CE in an evaluation of Basic.

Q. The entry goes on to say, "Asked for latest figure on 1978. Said we gave him \$4,600,000. I said he should use \$5,500,000 plus."

What do the figures 4,600,000 or 5,500,000 relate to; is that profit, sales? A. That was the projected earnings of Basic Incorporated as prepared in November 1977 or [599] December 1977.

Q. 4.6 million was the projection in December of 1977?

A. The projection for 1978, as prepared very late in the year of 1977.

Q. When did you give him that figure?

MR. MADSEN: Which figure?

MR. CROSS: 4.6 million.

A. I do not recall when he was given that figure.

Q. Do you recall, was it before or after the meeting at Burke Lakefront Airport? A. I do not recall when it was.

Q. Do you recall giving Mr. Kelly any financial data, other than in connection with Mr. Insley's visits to Cleveland, following the Burke Lakefront Airport meeting? A. I do not recall.

Q. Do you recall the circumstances under which you gave Mr. Kelly a 4.6 million dollar projection? A. I don't recall the time or the occasion when we gave it to him, so I do not recall the circumstances.

Q. Was that 4.6 million dollar projection [600] public information?

MR. MADSEN: Object to the form of the question.

A. No.

Q. It was not generally available to the public? A. No.

Q. On July 13, 1978 you apparently indicated to Mr. Kelly that he should be using a 5.5 million dollar figure or a figure in excess of 5.5 million dollars, is that right? A. I don't know where the excess comes from.

Q. Well, it says 5.5 plus. A. It might be, yes. That's what I might have given him.

Q. Is that what you told him? A. I presume, having made the note. I do not recall having told him that.

Q. Do you recall, what was the basis of that \$5,500,000 figure? A. It was the result of an update of our earnings projection for 1978.

Q. Do you recall when that update was done? A. No, I do not. * * * *

[632] * * * * Q. Following your conversation with Mr. Kelly on or about July 18, 1978, do you recall communicating with anyone at Jones, Day regarding further antitrust review?

MR. MADSEN: By communicate, do you mean either orally or in writing?

MR. CROSS: Yes.

Q. Do you recall any further contact with Jones, Day? A. Yes, I do.

Q. When? A. Mr. Caito was in contact with Mr. Steinhouse until well into July. I don't know the date.

Q. Did you direct Mr. Caito to send any information to Mr. Steinhouse, or was this going on without your direction? A. This was the result of the meeting in Mr. Rose's office where we had commissioned Mr. Steinhouse, and whatever information Mr. Steinhouse needed, he could obtain from Mr. [633] Caito, who had the records of our sales breakdown.

Q. Do you recall discussing with Mr. Caito the need to update the information he had given to Mr. Steinhouse in June? A. I recollect that there was a correction to be made.

Q. But do you recall discussing that with Mr. Caito. A. Yes.

Q. Did you direct him to update the data after your conversation with Mr. Kelly on July 18? A. He needed no direction. He did it in conformance with the assignment to give Mr. Steinhouse information that was required.

MR. CROSS: I would like to have the reporter mark as Plaintiff's Exhibit 92 what appears to be a file copy of a letter dated July 21, 1978 from Anthony Caito to Carl Steinhouse attached to which is a letter dated June 21, 1978 from Mr. Caito which encloses two pages of a variety of sales data.

[642] Q. And the others say sales? A. Yes.

Q. And down the left-hand column are lists of products, aren't they? A. Products are listed in the left-hand column.

Q. And those are the products that Basic manufactured? A. Yes, they are.

Q. And is that information public, broken down that way? A. Not to my knowledge.

Q. And you sent it to Mr. Kelly? A. I did.

Q. Pursuant to his request? A. Yes. * * * *

[653] * * * * Q. Let me direct your attention in particular to the first page of the exhibit, which refers to the attached financial statements as, and I quote, "The analysis we usually make in considering mergers or acquisitions."

Is that a fair description of the documents that are annexed to Plaintiff's Exhibit 151? A. That's a fair description.

Q. Were you aware that analyses usually made in considering mergers or acquisitions were prepared for Basic and Combustion together in or about June of 1977? A. Yes—I do not know. My earlier statement, I do not recall when they were made.

Q. You became aware that such documents were being made at some point in time, is that right?

[803] * * * * Q. Mr. Muller, directing your attention to page 392 of your transcript, beginning on line 7, referring to July 18th, you were asked, and I quote:

"Q. What was your understanding at that time of the status of that? I understand that it was not discussed at that conversation. A. The understanding was that Combustion Engineering may at some time in the future approach us with an informal offer.

Q. What was your next contact with Mr. Kelly subsequent to that conversation?"

He's referring to the first conversation that occurred on July 18th.

"A. I believe it was a few hours later that same day.

Q. Did he call you or did you call him? A. My notes indicate that he called me.

Q. Do you have a recollection of that second conversation occurring? [804] A. I have a recollection that he talked about a further inquiry into the Federal Trade aspect; and I do not recollect anything beyond what my notes reflect.

Q. Your notes indicate that Mr. Kelly called you regarding an antitrust meeting on July 28 in New York. Who was that meeting supposed to be attended by? A. It was to be attended by CE lawyers.

Q. Anybody else? A. Not that I am aware of.

Q. It was just a meeting of Combustion Engineering lawyers among themselves? A. No. They were to go to Washington and test Washington."

Does that fairly and accurately represent your testimony before the SEC? A. No reason to think otherwise. * * * *

[805] * * * * Q. Was it your understanding, at the time that Mr. Kelly told you about a meeting in New York to be attended only by the CE lawyers, that he was referring to a meeting to discuss an acquisition of Basic by Combustion or an acquisition of Combustion Engineering's refractories division by Basic?

MR. JEAUVONS: Or something else?

MR. ELKIND: Or something else.

A. I do not recall that he gave the specific reason.

Q. Mr. Muller, you were asked, at page 394 of your SEC testimony, in reference to the July 18th telephone conversation with Mr. Kelly concerning the Kaiser-Levino case, and I quote:

"Q. Do you have any reason to believe that it was not in connection with a possible [806] merger of Combustion and Basic? A. I do not."

Do you recall giving that testimony before the SEC?

* * * * A. I do not recall giving that testimony.

Q. Well, do you recall testifying that you had no reason to believe that the discussion about the Kaiser-Levino case was in connection with anything other than an acquisition of Basic by Combustion? * * * *

[807] * * * * Q. Do you have any reason to believe that that testimony was untrue? A. No.

[818] * * * * Q. Mr. Muller, I'd like to direct your attention to your testimony before the SEC on November 14, 1979, page 389, beginning on line 15.

Have you had a chance to read pages 388 through 389 of your transcript? A. I did.

Q. Referring to your testimony beginning on page 389, line 15, can you locate that? A. Yes.

Q. Referring to your conversations with Mr. Kelly on July 18th, 1978 you were asked, and I quote, as follows:

"Q. What else, if anything, was discussed in that conversation with Mr. Kelly? A. Relying on my notes, now, we talked about some SIC numbers.

Q. Was Mr. Kelly asking you for information about Basic's sales of certain— A. (Interrupting) He was asking me about certain sales dollars classified with [819] certain SIC numbers.

Q. Do you know what the purpose of his inquiry of those SIC number sales was? A. I did not know, but I assumed—

MR. MADSEN: I don't want you to assume.

A. All right. I did not know.

Q. (By Mr. Wachterman) Why did you give him that information? A. All right. Because he had announced that Combustion Engineering might prepare an informal offer; and that the Federal Trade aspect would be looked into once more. So, I was helpful to him in giving him those numbers.

Q. An informal offer for the possible acquisition of Basic by Combustion Engineering? A. That's correct."

Does that fairly and accurately represent your testimony before the SEC, Mr. Muller? A. I have no reason to think otherwise.

Q. Do you have any reason to think that that testimony was incorrect? A. I do not.

Q. And do you recall that the reason you [820] gave Mr. Kelly financial information concerning Basic was the fact that Mr. Kelly was preparing an informal offer for the acquisition of Basic by Combustion?

MR. JEAUVONS: Objection. Would you read the question back, please?

(Record read.)

Q. Do you recall that? A. No, I do not.

Q. Well, do you have any reason to believe that your testimony on page 390 between lines 5 and 9 is incorrect, when you said, and I quote:

MR. JEAUVONS: You've already asked him that.

Q. "Q. Why did you give him this information? A. All right. Because he announced that Combustion Engineering might prepare an informal offer—"

MR. STERNMAN: I think the record shows that he was looking at his notes at the time he gave the testimony.

Q. Do you want to take a look at your notes again? [821]
A. No, I don't.

Q. Here is the note for July 18, 1978. A. In your question you stated that Mr. Kelly was preparing an offer. Mr. Kelly informed me that he might prepare an offer.

Q. Was the fact that Mr. Kelly had informed you that he might prepare an offer for Combustion to acquire Basic the reason that you gave Mr. Kelly the information concerning Basic's finances? A. Yes, and I had another purpose. It would also assist us to clarify the point that I was trying to clear up about Basic buying Combustion Engineering's refractories division.

Q. Well, how would your giving Mr. Kelly financial information about Basic assist you in clarifying the point that you say you were trying to clear up as of July 18, 1978 concerning Combustion's acquiring Basic?

MR. JEAVONS: Excuse me. It wasn't just financial information—

A. The financial information was restricted to a tiny portion of Basic's sales on product lines where there might exist an overlap.

[857] * * * * Q. My question to you now, Mr. Muller, is was the testimony that I just read into the record from your testimony before the SEC truthful testimony?
A. Yes. * * * *

Q. Mr. Muller, do you recall taking a trip to Europe between on or about September 9, 1978 and October 12, 1978? A. I do not recall.

Q. Do you recall traveling to Switzerland, [858] Sweden and Denmark during that time frame? A. I remember having traveled but I'm— * * * *

Q. Mr. Muller, at the SEC testimony Mr. Madsen read into the record a statement that you were out of the country during the period from about September 9, 1978 until about October

12, 1978 and that you traveled to Switzerland, Sweden and Denmark.

Do you have any reason to believe that that's inaccurate? [859] A. No reason to believe otherwise.

Q. You do recall making such a trip. A. I do.

Q. Were you in communication with your office while you were in Europe? A. Yes.

Q. With what frequency; how frequently were you in contact with your office? A. I do not recall how many times.

Q. Did you call the office or did you speak to the office more than once a week? A. I do not recall the frequency.

Q. Do you recall whether you were in touch with the office every day?

I'm not asking for a precise number. A. I was not in touch with the office every day. * * * *

[872] * * * * Q. Mr. Muller, was Kidder Peabody performing services for you in the months of August, September, October and November of 1978? A. To the best of my recollection, yes.

Q. And were they working on the appraisal that you had referred to at an earlier point in time in your testimony? A. They were supposed to.

Q. How do you know they were supposed to; because Mr. Ludwig had asked them to? A. Yes.

Q. And he had told you that he had asked them to work on that appraisal? A. Yes.

Q. During the period August, September, October and November of 1978 was Jones, Day performing any kind of investigation into the possible antitrust consequences of an acquisition of Basic by Combustion, to your knowledge? A. I do not recall one way or the other * * * *

[886] * * * * Q. Did he tell you what he had told the New York Stock Exchange in response to their inquiry? A. I do not recall.

Q. Did he tell you whether he had disclosed Basic's discussions with Combustion Engineering to the New York Stock Exchange? A. I do not recall that he did.

Q. Did you speak with anybody other than Mr. Ludwig during the course of that telephone conversation? A. No.

Q. You didn't speak to the Jones, Day lawyer yourself? A. I did not.

Q. During the telephone conversation did you talk with Mr. Ludwig about the advisability of disclosing the discussions that had occurred between Basic and Combustion Engineering? A. I do not recall doing it.

Q. Did you ask him whether the attorney from Jones, Day had been apprised of the discussions between Basic and Combustion [887] Engineering? A. I do not recall.

Q. Well, did he tell you whether the attorney from Jones, Day had been advised of the discussions between Basic and Combustion Engineering? A. I do not recall that he did.
* * * *

[894] * * * * Q. Did you talk, in the course of that review, about whether the discussions between Basic and Combustion Engineering should be disclosed? A. Not to my recollection.

Q. Do you know whether there was such a discussion at the audit committee meeting? A. I was not present.

Q. Did anybody inform you that there had been such a discussion? A. No, nobody informed me.

Q. Did you suggest to anybody that the discussions between Basic and Combustion Engineering should be raised at the audit committee meeting at which the language of the nine month interim report was reviewed? [895] A. No. * * * *

[911] * * * * Q. Mr. Muller, can you tell me what you meant when you said it was in your mind that Mr. Kelly wanted to speak to you about the possibility of Combustion acquiring Basic?

[913] * * * * A. In my mind was an assumption that Mr. Kelly would revive a dead subject of Combustion acquiring Basic, and that would give me the opportunity, if it arose, to revive a dead subject of Basic buying CE's refractories division.

Q. It's your testimony here today that you considered those to be dead subjects? * * * * A. Yes. We had not heard for months; we considered them dead. * * * *

**Excerpts from the Examination of Max Muller
by the SEC**

[177] * * * * Q. Why had you initiated that contact? A. The Refractors Division of Basic, Incorporated covers the field of what is known in the trade as basic refractories, made up of magnesite, dolomite and chrome. For the past few years we had endeavored to expand into the area of what is known in the trade as acid refractories, the line comprising alumina products, fire clay products, et cetera. We were unsuccessful in our efforts to acquire small companies active in that field. CE's Refractors Division were covering this field that I just mentioned and were practically not active in the field of "basic refractory products." Hence, we decided to approach Combustion Engineering, explore their willingness to sell their Refractories Division to Basic, to clear up that situation with an answer "Yes" or "No," so that we could then proceed along the lines we had earlier embarked upon, i.e., to enter by our own efforts the "acid refractory field."

This was the rationale behind our initiation of the meeting on February 27th, which took place at the Burke Airport in the morning between Ludwig, Kelly and myself.

Q. What was discussed at that meeting? A. At that meeting I advanced our company's desire to purchase from Combustion Engineering their Refractors Division, using such arguments that refractory was really not germane to [178] the business of Combustion Engineering, and that it would make

more sense if that Refractors Division were part of Basic, Incorporated.

Q. Did you make the initial presentation at that meeting? A. I made a presentation very similar to what I just went through now.

Q. And what was Mr. Kelly's response? Did he say anything in response to that? A. Yes. Mr. Kelly seemed responsive. He said, "We should pursue this further." He said, "Perhaps Basic shares could be used as a means of compensation," and that he would like to reflect upon our proposal.

Q. Was anything discussed at that meeting besides Basic's possible purchase of certain defractories from Combustion Engineering? A. Not to my knowledge.

Q. There was no discussion of any possible merger or a combination of Basic and Combustion Engineering? A. None whatsoever.

Q. As of that time, February 27, 1978, what was the status of the discussions you had had with Mr. Kelly about a possible combination of Basic and Combustion Engineering? A. It had appeared to me that there was a slowdown and perhaps a lack of interest on Mr. Kelly's part, although we had talked about other subjects from time to time.

[267] A. No understanding whatsoever, merely the repeated statements of Mr. Kelly that he would not like to read in the papers that Basic had been sold to, sold or raided. * * * *

[278] * * * * MR. WACHTERMAN: Why did Basic give Combustion Engineering their forecasts of sales and earnings?

A. Because, and again my recollection now, is that Mr. Kelly had mentioned the possibility of selling the refractorys division for some basic shares. * * * *

[293] * * * * Q. And what did Mr. Kelly say in response to what the Basic people said about these Combustion Engineering Refractories Division? A. He said that he deemed the offer far too low. You see, the refractories division was represented, and * * * *

[295] refractory division, and that under no circumstances would they consider selling the mineral division, and the conversation turned and again, with my recollection, Mr. Kelly said I do agree that the two refractories divisions would be functional and work well together, so why don't we go back to our original concept and have C.E. acquire Basic?

Q. When you say original concept— A. (Interrupting) The concept that he had had ten, twelve or fifteen years ago, or so, at one time.

Q. And did you respond to that? A. I don't recall how we responded.

Q. What else, if anything, did he say concerning the possible acquisition of Basic by C. & E.? A. As I said before, he agreed with us that the two refractories divisions together would make a good entity, and he said what would you think if Combustion might consider something like a 28 dollar price for your shares?

Q. Did he say something like 28 dollars to indicate more or less? A. I do not recall. It was not an authorized offer. It was not anything. It was merely on the order of, or sort of a general statement, but the figure 28 dollars was definitely mentioned by him, as I recall.

[296] Q. Is that the first time you had ever had any discussion with Mr. Kelly about a price, which Combustion Engineering might acquire Basic for? A. With all my conversations with Mr. Kelly, that was the first time that a dollar figure was ever mentioned.

Q. Have you ever heard any other dollar figures in any conversation with anybody, in connection with the possible acquisition of Basic by Combustion Engineering? A. No, I did not.

Q. You said that that was not an authorized offer. Did you inquire if it was an authorized offer? A. No. But it was phrased as what would be your reaction if Combustion Engineering were to come forth with an offer of that magnitude at that level? * * * *

[321] * * * * Q. How long a conversation was that? A. Perhaps five minutes, in the order of five minutes.

Q. What did Mr. Kelly say to you during that conversation? A. Again, not speaking from my own recollection.

Q. There is no need to tell me what is written down. A. My notes refresh my memory, and he informed [322] me that he would prepare an informal— * * * *

A. Yes, I do. Mr. Kelly said that he had given consideration to the entire matter and that he would prepare an informal offer for Basic Incorporated.

BY MR. WACHTERMAN:

Q. Was there any discussion of the form that offer would take? A. No, there was no discussion as to the form.

Q. Any discussion of the price that that offer would be? A. None was mentioned, no price was mentioned.

Q. Did you in any way indicate any preference that you had or that anybody else had concerning the type of offer that it should be? A. No, I did not. I was still actively passive.

Q. There was no discussion of possible tax effects? A. Nothing was discussed.

[323] Q. Did Mr. Kelly, in any way, indicate anything about that offer that he would prepare? A. He did not say anything about it, or any substance or concept that he had in mind.

Q. What else, if anything, was said during that conversation? A. He said that this was to be a very informal offer, and therefore, there was no need at this time, to mention it outside of the Kelly-Muller conversation circle.

Q. Did he say what he meant by an informal offer? A. He did not.

Q. What was your understanding of that? A. I did not inquire, and did not make an attempt to interpret what he meant by informal offer.

Q. Your offer, excuse me, your note advised against public disclosure, does that mean that Mr. Kelly did that, or you did that? A. Mr. Kelly did that.

Q. Did Mr. Kelly say anything else during that conversation? A. I do not recall that he said anything else.

Q. Did he indicate to you when you might expect to see the informal offer? A. No. * * * *

[324] A. He gave me no indication, and as I said before, I did not ask him.

Q. The next entry in your page four of Tab 10, Thomas Exhibit No. 3 refers to your telling Mr. Kelly that you would ask Kitter-Peabody for appraisal.

Did you tell him that? A. I did tell him that, and as I recall, I told him that we had employed the services of Kitter-Peabody to assist us in all matters of finance and that we, ourselves, had commissioned Kitter-Peabody to prepare an appraisal of the value of our company.

Q. That you had done that? A. That we had employed the services of Kitter-Peabody. I do not recall whether I used the past or the future tense.

Q. Your note states, M M informs K that we, w-e-'-l-l (spelling), that does indicate the future, does it not? A. Yes.

Q. Had you, at that point in time, already asked Kitter-Peabody for an appraisal? A. To the best of my recollection, we had already employed Kitter-Peabody. We had signed a contract with them to assist us in financial matters.

Q. Had you asked them for an appraisal? [325] A. I do not know if we had at this time, or not.

Q. Subsequent to that conversation with Mr. Kelly, did you do what you indicated you told him you were going to do? A. Through Mr. Ludwig, we commissioned or had commissioned already, Kitter-Peabody to make an appraisal of Basic, or the value of Basic Incorporated.

Q. I am not sure. You told Mr. Kelly you were going to ask Kitter-Peabody for an appraisal. As a result of that conversation, did you have a conversation with Mr. Ludwig concerning such an appraisal? A. I stated prior that my memory is not clear whether this reflects, this w-e-l-l (spelling) was correct, whether we had not already taken some steps, or whether we would take them, subsequent. I do not recall the sequence.

I do not recall whether this entry here, w-e-'-l-l (spelling) is or was correct. It may well be, in which case, subsequently I talked to Mr. Ludwig, and told him that we should proceed with what we had hired, Kitter-Peabody originally anyhow, to do. But we had probably proceeded with definite instructions.

Q. Concerning an appraisal? A. Yes, the appraisal value and the opinion of Kitter-Peabody of Basic Incorporated.

[326] Q. What was the purpose of seeking appraisal from Kitter-Peabody? A. We deemed it wise to establish a plan so that we were prepared against an unwanted raid.

And Kitter-Peabody is one of the firms who seemed competent in that field. We had employed them to assist us in the preparation of a plan in case of unwanted mergers, or tender offers. And for that purpose, we needed an appraisal also.

Q. What was the relationship between the appraisal and the plan against an unwanted takeover? A. The plan comprised the work by Jones-Day, the legal advice, and it would comprise also an evaluation and appraisal of Basic Incorporated.

Q. I don't understand what the purpose of the appraisal was in this plan? A. To react intelligently to a tender offer.

Q. To an unwanted tender offer? Or to any tender offer? A. To an unwanted tender offer, and also to friendly tender offers. But, the main purpose was to be prepared to act intelligently and in the shareholder's best interest, to an unwanted tender offer.

Q. The notation in your July 10th, '78 entry, with respect to Mr. Kelly's call, advised against public [327] disclosure. How did that come up in the conversation? A. I do not recall.

Q. Did you ask Mr. Kelly if it would be advisable at that point, to make public disclosure? A. I don't think so. I don't know whether I asked him or whether he volunteered this advice to me.

Q. Prior to that time, July 10th, '78, had you ever had any discussions concerning whether public disclosure of any of these discussions should have been made?

MR. MADSEN: Are you asking him about discussions with Mr. Kelly?

MR. WACHTERMAN: With anybody.

A. Not with Mr. Kelly.

MR. WACHTERMAN: With anybody?

A. With Counsel.

MR. WACHTERMAN: Anybody else?

A. Nope.

BY MR. WACHTERMAN:

Q. Did you, on July 10th, 1978, tell Mr. Kelly that you had discussed with Counsel, whether or not public disclosure should be made? A. I do not recall.

Q. Had you at any time prior, ever discussed with Mr. Kelly the advice that you had received from Counsel concerning public disclosure? [328] A. To the best of my knowledge, no.

Q. Did you inform Kitter-Peabody that on or around July 10th, 1978, that Combustion Engineering and Mr. Kelly was preparing to make an informal offer to purchase Basic? A. I did not. I delegated the contact to Mr. Ludwig.

Q. Did you discuss with Mr. Ludwig, well, did you have a desire for Kitter-Peabody to be informed of this? A. I did not discuss that with Mr. Ludwig.

Q. You did discuss that Mr.—you informed Mr. Ludwig, and Mr. Kato that there was an informal offer? A. I informed them of my conversation with Mr. Kelly, yes.

Q. Do you know if Mr. Ludwig informed Kitter-Peabody of this contact? A. I do not know that.

Q. To your knowledge, has anyone else besides Mr. Ludwig or Mr. Kato and unto yourself and Mr. Kelly, were they aware of this conversation concerning an informal offer to be prepared? A. Yes, Counsel.

Q. Anyone else? A. No.

Q. Subsequent to that conversation with Mr. Kelly, [329] did you and Mr. Kato and/or Mr. Ludwig discuss Basic's posture at that time, with respect to Combustion Engineering and the informal offer that might be made? A. Not to my knowledge. I merely informed both of them of Mr. Kelly's call.

Q. There was no discussion about what an offer might be? A. No, there was no discussion.

Q. Was there a discussion of what a favorable offer might constitute? A. No, no discussions at all, about any value or figures.

Q. What was your next contact with Mr. Kelly? A. Again, relying on my diary that was on the 13th of July.

Q. Do you have any recollection of that contact between the 10th and the 13th? A. To my knowledge, there was none.

Q. Excuse me, back to the July 10th conversation, was anything else discussed besides that which you just testified to? A. Not that I recall. * * * *

[352] Q. You hadn't given it to your bankers at that point? A. No, because it was in pencil. It was merely an update in pencil in our own form.

MR. WACHTERMAN: You say update in pencil? You were giving this information to Mr. Kelly over the telephone, were you not?

A. Yes.

MR. WACHTERMAN: When you said a pencil update, you are referring to your source of the information?

A. To the source of information that came out of Mr. Ludwig's office.

MR. WACHTERMAN: When had he given you that?

A. I do not recall how much prior to this time he had given this to me.

MR. WACHTERMAN: And when we asked you if you had ever given that figure out to anybody else, we are also interested in knowing if anyone else at Basic had given out that figure to anyone else.

A. To my knowledge, no one else had given that figure out.

Q. Including the bankers? A. Right. Including the bankers.

Q. Why did you give that figure to Mr. Kelly? A. Combustion Engineering seemed serious about [353] preparing an informal offer; and in the interests of the company, they should have a reasonable estimate of what 1978 would like for them to prepare an intelligent offer.

Q. You gave them this forecast to assist them in preparing this offer? A. Yes.

Q. Did you have any discussions with Mr. Kelly during that conversation about the possibility of public disclosure of the discussions between Combustion Engineering and Basic, Inc.? A. No.

Q. Did you have any discussions with anyone concerning the possibility of such disclosures in connection with the July 13, 1978, phone call with Mr. Kelly? A. I informed Mr. Kato and Ludwig but no one else of this conversation.

Q. Did you have any discussion with anybody else about the desirability or the possibility of making public disclosure of your conversations with Combustion Engineering? A. No, I did not.

MR. STERNMAN: And by that, you are referring to the July 13th meeting or conversation?

MR. WACHTERMAN: Yes.

[392] To my knowledge, there was nothing else discussed.

Q. What was your understanding at that time of the status of a possible informal offer in which Combustion Engineering was considering preparing? A. It was not discussed.

Q. What was your understanding at that time of the status of that. I understand that it was not discussed at that conversation. A. The understanding was that Combustion Engineering may at some time in the future approach us with an informal offer.

Q. What was your next contact with Mr. Kelly subsequent to that conversation? A. I believe it was a few hours later that same day.

Q. Did he call you or did you call him? A. My notes indicate that he called me.

Q. Do you have a recollection of that second conversation occurring? A. I have a recollection that he talked about a further inquiry into the Federal Trade aspect; and I do not recollect anything beyond what my notes reflect.

Q. Your notes indicate that Mr. Kelly called you regarding an anti-trust meeting on July 28th, in New York. [393] Who was that meeting supposed to be attended by? A. It was to be attended by C. E. Lawyers.

Q. Anybody else? A. Not that I am aware of.

Q. It was just a meeting of Combustion Engineering Lawyers among themselves? A. No. They were to go to Washington and test "Washington."

MR. STERNMAN: He is asking you about the July 28th meeting in New York.

A. That's what I am talking about.

MR. STERNMAN: He is asking who was supposed to be at that meeting in New York.

A. Oh, okay. C. E. in house lawyers with C. E. outside lawyers. I am sorry. I misunderstood. I didn't quite understand the question.

Q. Do you know if that meeting ever took place? A. I do not know.

Q. (By Mr. Wachterman) Did you have any further conversations with Mr. Kelly about that meeting? A. Not to my knowledge.

Q. Your notes refer to Kelly saying something about a good time to test Washington with regard to the Kaiser-Levino Case. What does that refer to? A. That refers to the F.T.C.'s challenge to Kaiser [394] for their purchase of the Levino Refractory company.

Q. My question goes to whether testing Washington about what? A. About the status of the Kaiser-Levino Case.

MR. STERNMAN: Are you speculating now?

A. I am speculating. Yeah. Thank you.

MR. STERNMAN: Don't do that.

A. I do not know.

Q. (By Mr. Wachterman) Your note states that K. said this would be a good time to test Washington on account of the Kaiser-Levino Case. Was that in reference to a possible merger

of Basic and Combustion Engineering? A. It might have been.

Q. Do you have any reason to believe that it was not in connection with a possible merger of Combustion and Basic? A. I do not.

Q. Do you know what else it might have been in connection with that you were talking to Mr. Kelly about at that time. This reference to K. here? A. No, I don't.

Q. In reference to July 18th, 1978, when was your next contact with Mr. Kelly? A. It was prior to—prior to November 27.

Q. Did you have any contact with Mr. Kelly during [395] August, September, or October of 1978? A. None.

Q. Not by telephone or in person? A. Not by telephone or in person.

Q. You are sure of that? A. I am sure of that.

Q. Did you have contact during that time period with anyone else from Combustion Engineering? A. I did not.

Q. Were you aware or are you aware of any contact between anybody else at Basic and Combustion Engineering during that time period? A. There was the possibility that Mr. Cato met with Mr. Hagerman (phonetic.) at the Refractory's Institute Directors Meeting. These meetings are held four times a year and a body of about 22 or 24 people and I do not know whether Mr. Hagerman (phonetic.) attended or if Mr. Cato attended. They sometimes could not make it; so I cannot say whether anyone from Basic met with anyone from Combustion Engineering during that time.

Q. What was the status during that time period of the discussions between Basic and Combustion Engineering concerning possible acquisition of Basic by Combustion Engineering? A. None.

[396] Q. Had you had any or had you received information from any source concerning the possible informal offer that Combustion was considering? A. No.

Q. Did there come a time during that time period, August, September, or October of 1979, when there was unusual trading activities in Basic, Incorporated? A. I do not recall. I would have to look at the stock sheets to determine that.

Q. Do you recall during that time period a release which Basic prepared concerning its lack of information concerning the causes for unusual stock trading? A. I do.

Q. What were the circumstances surrounding that release prepared by Basic? A. I was in Europe at the time. Mr. Ludwig called me and informed me that there had been another flurry in our activities and a release seemed to be in order. I instructed him to go ahead.

He called me back. He read the release to me over the telephone which I approved and which was issued. * * * *

[397] Q. In your discussions with Mr. Ludwig concerning the release, did you discuss whether he had consulted with anyone else about the proposed release? A. No, I did not.

Q. Do you know whether, in fact, he did consult with anyone else about that release? A. No.

Q. Do you know if he consulted with Counsel about that release? A. I do not.

Q. But he didn't tell you he had or had not consulted with anyone else? A. He did not tell me if he had or had not.

Q. Did you and Mr. Ludwig discuss the possibility of making some public disclosure about any activities that Basic was engaged in at the time of that release?

MR. MADSEN: May I have that reread?

A. Describe the activities—

MR. STERNMAN: We want to have the question reread first, please.

(The pending question was read by the reporter.)

MR. STERNMAN: I think Mr. Muller was about to ask you to describe what you meant by activity. * * * *

[398] * * * * MR. WACHTERMAN: I want to know if you and Mr. Ludwig and you and Mr. Ludwig discussed the possibility of saying anything in that release other than what you did, in fact, say.

A. No. We did not.

Q. (By Mr. Rachterman) You and Mr. Ludwig did not discuss the possibilities of making some disclosures concerning the discussion between Basic and Combustion Engineering?

MR. STERNMAN: In the context of unusual trading activity which was the context of that release.

MR. WACHTERMAN: In deciding what to put in that release.

MR. STERNMAN: On the subject of unusual trading activity?

MR. WACHTERMAN: No subject. They had a discussion concerning the release; and I am asking about that discussion about that release.

MR. STERNMAN: Mr. Muller testified that Mr. Ludwig had called him about another flurry; and a release seemed appropriate in light of that flurry; so the only discussion is to what should the context and content be in their release respecting that flurry.

[399] MR. WACHTERMAN: Did you have discussions with Mr. Ludwig about what the subject matter of the release would be?

A. He read it to me.

Q. Prior to his reading it to you, did you discuss with him the fact that there would be a release made? A. No. He said he was preparing a release and he would read it to me.

Q. No discussion was prior to his reading it to you of what the subject matter of this release would be? A. I asked him if he had any information about the reason for the flurry; and he told me, "Absolutely not." So the release was written as it was and released as it was read to me.

Q. And he read the release to you and you approved it? A. Yes.

Q. In connection with his reading that release to you and your approving it, did you have any discussions with him concerning whether or not the release should include information about the discussions between Basic and Combustion Engineering? A. No. We did not discuss that.

[400] Q. In connection with Mr. Ludwig's reading of a release to you and your approving it, did you have any discussions concerning any other activities or information that might be disclosed in the release? A. No.

Q. In your discussions with Mr. Ludwig concerning what might be causing this trading activity, did you discuss with him the possibility that information concerning Basic's discussions with Combustion Engineering might have been causing the trading surge? A. No. * * * *

Q. (By Mr. Wachterman) Mr. Muller, in connection with the September 1978, release, was that release prompted only by the trading activity in Basic? A. Yes.

Q. Was Mr. Ludwig, did he inform you of any inquiries by anybody concerning possible reasons for activity that might prompt the release? [401] A. To the best of my knowledge, he had mentioned that there had been a telephone conversation with either the S.E.C. or the New York Stock Exchange. I can never keep the two apart.

MR. STERNMAN: That is not responsive to anything.

Q. (By Mr. Wachterman) Did he say he had received that telephone call from one of those two organizations? A. He talked in the "we" sense of the word; so I could not recollect whether he or Mr. Thomas had been—Well, if they were the ones that had been contacted.

Q. Did he say what had been said during that conversation? A. That the S.E.C. or the N.Y.E. whichever it was either suggested or was supportive of the issuance of a release.

Q. Did he say anything else about that conversation? A. Not to my knowledge.

Q. Did he say what, if anything, he had told the people who called him from one of those two organizations concerning the trading activity at Basic? A. To the best of my knowledge he had informed them that the company knows of no reason for the activity, and that this would be reflected in the release.

Q. He didn't tell them anything about any [402] conversation between Combustion Engineering and Basic concerning a possible takeover? A. That I do not know; but to my knowledge, he did not.

Q. He didn't tell you about telling them any such thing? A. He did not tell me about that, no.

Q. Did Mr. Ludwig in connection with his telephone calls to you in Europe concerning the trading activity, did he indicate whether he had made any attempts to find out what was causing that trading activity? A. He did not.

Q. Do you have any reason to know whether he did make such attempts? A. No. No reason to know.

Q. When you were in Europe on this trip when Mr. Ludwig called you, did you have contact with anybody else in the United States? A. No, I did not.

Q. The two telephone calls from Mr. Ludwig were the only contacts you had with anyone in the United States? A. Yes.

Q. You didn't have any contact with Mr. Kelly during that trip? [403] A. No, I did not.

(Pause.)

Q. (Mr. Meadows) Mr. Muller, referring to Page Five, Tab Ten of Thomas Exhibit No. 3, the first entry on that page, what does that entry indicate? A. A telephone call from Mr. Kelly announcing a routine visit to Cleveland. M.M. says, "Come see us."

Q. As far as the date of that call, that is November Question Mark there. A. To the best of my recollection it was a few days before the 27th of November.

Q. You don't recall the date? A. No, I do not recall the exact date; but it was very short notice. That I do recall.

Q. Was it a regular working day as opposed to a weekend? A. Yes. A regular working day.

Q. It was a call to your office? A. Yes.

Q. Did Mr. Kelly characterize his visit as routine? A. Yes, he did.

Q. What did you understand that to mean? A. Combustion Engineering under Mr. Kelly's direction has several operations in Cleveland. He visits [404] Cleveland very regularly; so he announced a routine visit to his other operations; and he said, "I am going to stop in."

And I said, "Come on ahead."

Q. All right. The routine applies to his other visits but not individually to Basic, Incorporated? A. Correct.

Q. Did he give you any indication of why he wanted to meet with you? A. None whatsoever.

Q. And I think you have indicated that this was the first contact you have had with Mr. Kelly since July? A. The first contact we had since July with Mr. Kelly, yes.

Q. Have you attempted to contact Mr. Kelly during that period of time? A. I never did.

Q. Did you ask him why he wanted to stop and visit with Basic? A. I did not.

Q. Was anything else discussed besides what else was reflected on this entry? A. Nothing else. It was a very, very short telephone conversation announcing his visit.

[405] Q. What is that next entry? A. The next entry is November 27.

MR. WACHTERMAN: The next entry on November 27 reflects the meeting with Mr. Kelly. Is that the meeting that you talked about in this telephone conversation that you just testified to?

A. To the best of my knowledge, I never testified about this meeting.

MR. STERNMAN: No. In the telephone conversation that we just talked about where Kelly said, "I am coming to Cleveland on a routine visit." Is this the routine visit?

A. This was the meeting that Mr. Kelly had announced a few days earlier over the phone.

MR. WACHTERMAN: Could you read for us that entry so it is clear what it says. And again, read; and not interpret. Just read it.

A. "11-27-78

J.K. visits Cleveland 10:30 a.m., 8:45 Hanna. We tell him 1978 could easily go over \$5.00 per share, keeping below by write-offs.

K. said a share-for-share deal was out of question on account of Basic's high trading prices. Kelly suggests cash or 49 per cent cash, 51 per cent stock, \$35.00 for the cash portion. We told Kelly that we would [406] ask Kitter Peabody to assist us.

Kelly proposed the possibility of First Boston (C.E.'s Banker) to meet with Kitter-P. Lunch Harmon Club. K. left at 2:00 p.m."

Q. (By Mr. Meadows) The entry, you told him 1978, that it would easy go \$5.00 a share. That was referring to earnings of Basic for 1978? A. Yes.

Q. Had you prepared anything—Well, what preparations did you make for this meeting? A. None.

Q. This figure of going over \$5.00 a share, this was something that you knew? A. Yes.

Q. How did this subject come up in the discussion? That is, the earnings for Basic for 1978? A. Mr. Kelly said that in spite of the long silence during the summer months, C.E. had not lost interest in their desire to come to an agreement with Basic; and that they would like to continue or to resurrect and start again some conversations about it.

Q. Was this— A. This is a free interpretation, to the best of my recollection, of Mr. Kelly's conversation.

Q. He initiated this subject, then, at the [407] beginning of this meeting. In other words, the subject of C. and E. still being interested in Basic? A. I do not know how, the manner that it started, or the minute that it started, or if we asked him where he had been all summer or what. But we thought C. E. had lost interest in Basic, and to the best of my recollection that was brought up and he made the statement, the gist of which I just gave you.

Q. Who was present at this meeting? A. At that meeting was present, Cato, Ludwig, Kelly and I.

Q. Where was that meeting held? A. 845 Hanna Building, in my office.

Q. Did Mr. Kelly ask you what the earnings for 1978, at that point, looked like for Basic? A. I do not recall whether we volunteered or if he asked.

Q. Did you ask him anything else about Combustion Engineering or in particular the status of Combustion Engineering's interest in Basic? A. Not to my recollection.

Q. (By Mr. Wachterman) Mr. Muller, after Mr. Kelly made his statement about a continuing interest of C. and E. in Basic, what happened then? A. Then we said, "Well, I presume—" [408] Q. Excuse me. Would you— A. (Interrupting.) Make us an informal offer as you had in the year.

Q. You said "we." Who said that? A. I cannot recall. The three of us talked all intermittently. We were acting pretty much as one body.

Q. And you referred to the informal offer that had been talked about in there. A. Earlier in the year, yes.

Q. And what did Mr. Kelly respond? A. Then he responded and said we might do that. A share-for-share deal was beyond their wish; and we might offer cash for 49 per cent of the stock and their stock for 51 per cent. Perhaps something like \$35 for the cash portion and C. E. shares for the other.

MR. STERNMAN: You haven't referred to your notes on the 11-27 meeting. It seems to me that you are just reading them or looking at them or reciting what they said.

A. I am refreshing my memory.

MR. STERNMAN: Does it refresh your memory independently of what's there is it because it's there that you know it's an accurate reflection of what happened?

A. Because it's here. I rely heavily on this.

MR. WACHTERMAN: Are the notes an accurate [409] reflection of what happened at that meeting as you recall?

A. They were intended to be.

MR. WACHTERMAN: At the time you wrote them?

A. Yeah.

MR. WACHTERMAN: Can you verify that now? Do you have an independent recollection of what happened at that meeting?

A. Not beyond these notes. To the best of my recollection, the notes reflect the salient points of the conversation.

Q. (By Mr. Wachterman) The notes reflect that Mr. Kelly said a share-for-share deal was out of the question. Did somebody pose a share-for-share deal, or did he just say a share-for-share deal is out of the question without any discussion prior to that time? A. I do not recall how this came about.

Q. Do you recall if you proposed a share-for-share deal at any time? A. I do not recall that.

Q. Were any subjects discussed at that meeting other than the possible acquisition of Basic by C. and E.? A. No.

Q. That was the sole point of discussion? A. (Nodded head.)

To my recollection, it was.

[410] Q. The \$5.00 a share figure that you mentioned at that meeting, had you ever disclosed that figure to anyone else outside of Basic prior to that time? A. I had not.

Q. Do you know if anyone else at Basic had? A. To the best of my recollection, no one ever had.

Q. The reference in your notes to keeping below by write-off, what does that refer to? A. We had some materials in inventory that we thought might be questioned by the auditors as to their value in the inventory; and to my recollection, there were some capital entries that had to go into expense items; so we anticipated that our accountant, Ernst and Ernst would suggest or insist on write-offs of some inventory or some other entries which, in fact, happened.

Q. When you say, "keeping below by write offs" are you referring to an attempt by you to keep below \$5.00 a share for some reason? A. No, no way at all. Merely that it might be kept below by the prescribed write offs.

Q. The notes refer to K. suggested cash or cash and stock. Had you ever had any previous discussions with Mr. Kelly concerning the structure of the deal that might be worked out between the two companies? [411] A. Never. * * * *

[412] * * * * Q. (By Mr. Wachterman) Your notes reflect that Mr. Kelly said, "A share-for-share deal is out." Mr. Kelly suggested cash and stock. Is it your recollection that Mr. Kelly

was making all of these initiatives on his own; not responding to any suggestions by you or questions by you. A. That is my recollection. He asked for the meeting; and he wanted to make his statements.

Q. Your notes reflect that you told Mr. Kelly that you would be asking Kitter-Peabody "to assist us." Had you had any prior contact with Kitter-Peabody prior to this time? A. They were in their second contract with us. Yes.

Q. What was the nature of the prior contract that you had had with Kitter-Peabody? A. I had met two or three of their staff when they were visiting Cleveland.

Q. What was the purpose of the meeting? A. The purpose of the meeting was for me to meet them.

Q. Who did you meet? A. I recollect that it was a Mr. Palmer from * * * *

**Excerpts from the deposition of Geoffrey Parker
by Respondents**

[9] * * * * Q. What were the titles of Mr. Goodson and Mr. Siegel during the period 1977 and 1978? A. They were vice presidents.

Q. Did there come a time when Basic Incorporated became a client of Kidder, Peabody? A. There did.

Q. When was that, sir? A. That was perhaps November 1977.

Q. Is that your best recollection? A. It is.

Q. What were the circumstances under which Basic Incorporated became a client of Kidder, Peabody? A. My recollection is that in October 1977 I initiated a call to Basic and made a visit there with Mr. Childs for the purpose of soliciting corporate finance business, and we discussed a number of services and in the following month they elected to become a retainer client of the firm's for financial advisory [10] services.

Q. You said that you discussed a number of services with Basic when you first approached them. What services did you discuss? A. We discussed general consulting, financial policies, financing and acquisitions.

Q. Was there something that caused you to solicit the business of Basic Incorporated? A. It appeared on the list that I developed of companies that were not being followed by other people in the corporate finance department. It seemed like a new target business company that I might have some success with. * * * *

[44] * * * * Q. Did Kidder, Peabody undertake to familiarize itself with the financial condition of Basic Incorporated during 1977? A. Yes.

Q. Did you undertake to prepare a valuation or to be in a position to prepare a valuation of Basic Incorporated? A. We undertook to be in a position to prepare a valuation if there's a reason to do so. * * * *

[121] Q. When was that?

Let me place before you your calendar, and let me ask you if that assists you to identify what it is in the calendar that helps you fix the dates. A. Well, my calendar indicates that I was at Basic on Monday and Tuesday, December 18th and 19th. Marty Siegel was called out there a few days earlier.

My recollection is that he went out on Thursday, December 14th, on or about that day.

It could have been Friday, the 15th. I'm not exactly sure, but the time periods is pretty compressed.

Q. Let me show you Plaintiffs' Exhibit 2 once again, and I will ask you to read the next-to-the-last entry on the page, if you would, sir. A. Next-to-the-last entry says:

"Marty's presentations"—or I guess it is "Marty: Presentation to senior management on December 14, 1978."

Q. What is the basis of your recollection Mr. Siegel made a trip to Basic on or about December 14, 1978? A. Mr. Siegel told me that he had received a call from Basic, and I believe that this is the preceding week. In other words, the week beginning the 11th of December, [122] and I couldn't be specific as to exactly what day of the week it was.

[107] * * * * Q. Was that your impression, that the company seemed to be a company that might want to be sold sometime? Did you form that opinion?

MR. FARLEY: We are talking about a conversation a year before he first approached Basic with Pat Calahan, so you are going back to 1976.

THE WITNESS: That is not quite correct.

MR. FARLEY: Put it in perspective.

THE WITNESS: The perspective is this: Before I initiated anything with Basic, I wanted to make sure that I didn't trip over the toes of somebody else in our organization that might be working on Basic, so I called our Chicago office and [108] talked to Pat Calahan, who had responsibility for covering Ohio, and in theory that company and that SEC testimony presumably seems to reflect my conversation with Calahan wherein he characterized Basic and he characterized Basic as a company having old management and a company that might possibly want to be sold sometime.

But my view, upon working with them, was that they had no interest in being sold and, in fact were mainly interested in having Kidder, Peabody shield them to the extent we were able from anybody taking them over.

Q. Did you ask the management of Basic whether they were engaged in discussions with other companies concerning the possible acquisition of Basic? A. No.

Q. Did they ever tell you they were, prior to December of 1978? A. They did not.

Q. I take it that you were not familiar with the discussions that were taking place between Basic and Combustion. A. Absolutely correct. * * * *

[This page intentionally left blank.]

He asked me to return the call, and I did return the call to Basic.

Q. Did he tell you who it was who had called him from Basic? A. I guess he gave me a call slip or told me to return the call to so-and-so at Basic. I don't know exactly who it was. It was either Max Mueller or Mat Ludwig. So I returned the call, but I was told that they wanted to speak with him, so I advised Marty of that, and we placed the call.

And shortly thereafter he went to Basic.

Q. You called Mr. Ludwig? A. I called whoever it was that had called Marty Siegel.

Q. You don't presently recall who that person was? A. No.

Q. What did they tell you when you called that person? A. They wanted to talk to Mr. Siegel.

Q. Did they tell you why they wanted to talk to Mr. Siegel rather than yourself? A. No.

[123] Q. You then told Mr. Siegel that Basic wanted to talk directly with him? A. Correct.

Q. What happened next concerning Basic? A. The next thing that happened was I got a call from Marty Siegel in Cleveland saying that they were negotiating and finalizing an agreement with Combustion Engineering, that we would work over the weekend to prepare our materials and go out the next morning with our recommendation.

Q. When did you get that call from Mr. Siegel in Cleveland? A. It was perhaps Thursday the 14th or Friday the 15th.

Q. Did Mr. Siegel talk to you about the purpose of his trip before he left? A. No.

Q. But you are certain that the call that you got from Mr. Siegel was prior to the weekend, that is, on either December 14th or December 15th? A. That is correct. Absolutely certain, because I had to get the project staffed, and we staffed it on Friday, the 15th and worked over the weekend. * * *

**Excerpts from the deposition of Joseph R. Perella
by Respondents**

[23] * * * Q. Do you recall whether you made a visit to Combustion Engineering at or about the time they first contacted First Boston concerning their interest in Basic? A. No.

Q. Let me direct your attention, Mr. Perella, to the testimony you gave before the SEC on page 23, beginning on line 3 of the transcript, which says, and I quote:

"Question: At that time that the request came, was there anyone else involved at First Boston besides yourself in responding to this request?

"Answer: There were certain individuals who prepared the analysis, and I believe accompanied me, one or more accompanied me to visit the company's headquarters to discuss the company, Basic, to discuss Basic.

"Question: You went to Combustion [24] Engineering to discuss Basic?

"Answer: Correct."

Does that refresh your recollection as to whether you made a trip to Combustion's offices at or about the time of the first contract by Combustion Engineering concerning Basic? A. I don't know if the question that was being asked of me then related to the first visit or not, or the time and place that the question is referring to.

Q. Let's go back to page 22, why don't you read questions and answers beginning on page 22 through page 23, and let's see if that refreshes your recollection. A. I believe in reading this, I was referring to a request for service by Combustion Engineering sometime in 1977, and a visit that I made up there.

Q. Does the testimony on pages 22 through 23, particularly line 14 on page 22 through page 23, refresh your recollection that you did in fact make a visit to Combustion Engineering in 1977 concerning Basic Incorporated? A. Yes.

Q. At whose request was that visit made? A. I don't recall.

[25] Q. Does the testimony that I have just referred to appear to you to fairly and accurately reflect your testimony before the SEC? A. Fairly and accurately?

Q. Yes. A. Yes. * * * *

* * * * Q. Do you have any reason to believe that your testimony on pages 22 and 23 is in any respect inaccurate? A. No.

Q. Do you recall with whom you met on the occasion of that 1977 visit to Combustion Engineering? A. No. I would only be speculating.

Q. Do you recall whether you prepared a report on Basic Incorporated for Combustion Engineering [26] at or about the time of that first visit in 1977? A. No.

Q. You don't recall one way or the other? A. No. I don't recall a report. * * * *

* * * * Q. I want to direct your attention to the first visit that you made to Combustion Engineering concerning the subject of Basic Incorporated. * * * *

* * * * Q. I am referring to the 1977 visit to which you referred. [27] A. What I recall about that visit is that the subject was Basic, and I don't recall whether or not there was a report, but what I do recall is that Combustion Engineering had an interest in the company as an acquisition.

Q. Do you recall who first told you that? A. I believe it was Mr. Kelly, but, again, that might be a speculation. * * * *

* * * * MR. ELKIND: I would like the reporter to mark as Plaintiff Perella Exhibit 3, a document previously marked in this case as Plaintiff's Exhibit 11, which is entitled "The First Boston Corporation, Combustion Engineering, Inc., Merger Consequences of Pooling of Interest Merger with Basic Incorporated."

The document bears the date 12/1/76 in the bottom left-hand corner.

I would like the reporter to mark as Plaintiff Perella Exhibit 4—* * * *

[28] * * * * I also ask the reporter to mark as Plaintiff Perella Exhibit 4, a document dated 12/1/76, with the heading "The First Boston Corporation, Combustion En-

gineering, Inc., Summary of Consequences of a Cash merger with Basic Incorporated."

(Document dated 12/1/76, marked Plaintiff's Perella Exhibit 3 for identification, as of this date.)

(Document dated 12/1/76, marked Plaintiff's Perella Exhibit 4 for identification, as of this date.)

Q. Mr. Perella, have you seen Plaintiff's Exhibit 3 before? * * * * [29] * * * * A. I can't recall whether I have seen it before. * * * *

* * * * Q. Have you seen analyses in the form of Plaintiff's Perella Exhibit 3 before? A. Yes.

Q. You recognize this as an analysis in the form prepared by First Boston Corporation? A. Yes.

Q. Could you identify the analysis that's been marked as Plaintiff Perella Exhibit 3? A. As I was about to say, it appears to be a schedule prepared by First Boston Corporation analyzing merger consequences and the pooling of interest, [30] merger with Basic. * * * *

* * * * Q. Does this appear to you to be a document prepared by the First Boston Corporation? A. Yes.

Q. And to be a document prepared by the merger and acquisition group of the First Boston Corporation? A. Yes.

Q. Operating under your direction? A. Yes. * * * *

[31] * * * * Q. Was Plaintiff Perella Exhibit 3 entitled "Merger Consequences of Pooling Interest Merger with Basic Incorporated," a document that was prepared at your request? A. I don't recall.

Q. Do you recognize the handwriting in the bottom right-hand corner of the document, which says, "can go to \$30 per Basic." A. No.

MR. ROLFE: It says something else below that. Do you know what that says?

MR. ELKIND: I think it says "can go to \$30 per Basic share without delution."

Q. Do you see the date December 1, 1976 in the bottom left-hand corner? A. Yes.

Q. Have you seen dates on the other analyses in this form prepared by First Boston Corporation? A. Yes.

Q. Can you tell me what that date signifies, based upon your familiarity with the procedures and those kinds of reports prepared by First Boston? A. Either the date the analysis was prepared, or the [32] date it was prepared.

Q. Does Plaintiff's Perella Exhibit 3 refresh your recollection as to the first time when First Boston prepared an analysis for Combustion Engineering concerning a possible acquisition of Basic? A. No.

Q. Mr. Perella, let me direct your attention now to Plaintiff Perella Exhibit 4. Have you seen that document before? A. I don't recall having seen it before.

Q. Have you seen documents in this form before? A. Yes.

Q. Prepared by First Boston Corporation? A. Yes.

Q. Does this appear to you based upon your experience, to be a document prepared by First Boston Corporation? A. Yes.

Q. Is this the kind of analysis that First Boston Corporation prepares in the ordinary course of business at the request of its clients? A. Yes. * * * *

[50] * * * * Q. Are you referring to a study that was done for Combustion Engineering on Basic Incorporated about one year prior to the date of this memorandum? A. That's correct.

Q. Who was Mr. Young? A. Mr. Young is the Young that I referred to earlier who works for me.

Q. Does that refresh your recollection as to the study that was prepared for Combustion Engineering on Basic, Inc. in 1977? A. No.

Q. Does that refresh your recollection about the fact that a study was prepared? A. No.

Q. The next entry says, and I quote, "Basic hired Kidder, Peabody because three largest share-holders want to sell tax free."

Would you tell me what that entry refers to? A. What does it refer to? I don't understand the question, what does it refer to.

Q. Tell me what that entry meant. A. I believe it speaks for itself.

[51] Q. Who told you that Basic had hired Kidder, Peabody? A. I believe Mr. Gross told me that.

Q. Who told you that Basic hired Kidder, Peabody because the three largest shareholders wanted to sell tax free? A. I believe Mr. Gross told me that.

Q. Could you tell me what he told you in that regard? A. No. I don't recall.

Q. When did he tell you that? A. I don't recall that.

Q. Did he tell you who the three largest shareholders were? A. No, I don't recall.

Q. Have you heard the name Eels, Howard Eels? A. No. I don't recall the name.

Q. Have you ever heard the name Max Mueller? A. The name rings a bell.

Q. Former chairman of Basic Incorporated. A. I recall the individual now.

Q. Do you recall being informed he was one of the three people who wanted to sell Basic tax free? A. No. * * * *

[60] MR. STERNMAN: Were these documents produced by First Boston?

MR. ELKIND: They were produced by First Boston.

Q. Have you seen Exhibit 8 before? A. I don't recall.

Q. Do you recall whether those are analyses that were prepared at your request? A. Judging from the date of 7/12/78, and the date of that memorandum, 7/11/78, I would say that this was prepared in response to my request to have certain material updated.

Q. The direction to have certain material updated was made at the request of Combustion Engineering, is that right?

MR. STERNMAN: I don't think that is what he testified to. In fact, I think he testified to the contrary.

I think you asked that question, and he said he didn't recall.

Q. Do you recall Combustion Engineering requesting the analyses that have been marked as Plaintiff Perella Exhibit 8?

MR. ROLFE: What you mean is, do you recall [61] whether they were requested or not.

THE WITNESS: When he asks these questions, it is almost inferring they requested what is requested in each column to be prepared.

That they give us the range to analyze and such like that.

Q. I don't mean that. A. We get nine million requests a year for analyzing companies that get acquired. We have a file room full of sheets like this.

And clients says we're interested in X company. Take a look at it.

MR. STERNMAN: You are making a general statement now, and—

THE WITNESS: I am trying to get this guy to understand that this is like a dentist drilling a cavity for me, okay? It isn't oral surgery.

Q. Mr. Perella, I am not asking you whether Combustion asked you to prepare a document with those numbers on it or in that precise form.

What I am asking you is, whether Plaintiff Perella Exhibit 9 is an analysis that was prepared pursuant to a request by Combustion Engineering for an analysis. [62] A. You are inferring by your question that they asked me to present specific analyses, and I don't recall what they requested.

Q. Did they make some kind of a request? A. What they indicated to me was an interest in Basic as an acquisition for Combustion, which clients do constantly during the day, during the year.

We are constantly grinding out schedules like this, analyzing potential acquisitions for clients.

So Mr. Gross, having indicated an interest on the part of the company in a telephone conversation, and an indication that they wanted to look at Basic as a possible acquisition, leads to an analysis like this. As to who requested this specific page to be done, is anybody's guess.

MR. STERNMAN: I move to strike the answer as speculative.

MR. ROLFE: Let's move on. I think he answered the question.

The answer is, he doesn't know.

MR. ELKIND: I appreciate your position, but the question hasn't been answered to my satisfaction.

[68] * * * * Q. Could you tell me what the purpose of this report was, if you have anything to add to your prior answer? A. Somebody at Combustion Engineering likes Basic. So they say, First Boston, you are an investment banker. Why don't you take a look at it.

We go into our hovel and grind out numbers and we take a look at Company B and we go up and we probably have a meeting with a client, and they take a look at our numbers.

That's how this stuff gets done. * * * *

[118] Q. By First Boston Corporation? A. Today I don't know who prepared this.

Q. Let me direct your attention to the SEC testimony beginning on page 64, line 22, which says, and I quote:

"THE WITNESS: Yes, this is an example of what a proposal letter would look like, if we were going to a split deal, 50 percent common and 45 percent cash, and you wanted to get a position on some report prior to the merger being effected, that would in some way account as a deterrent to someone else coming in.

"That is typically what happens any time you are involved in acquisition analysis, is that you ask, in the what-if type of discussion, were we to announce a deal for a company like this, would you think that there would be a lots of competition for a company of this kind?

"Like you have in a lot of your situations today, you have two and three companies bidding for the same property. So that one always looks factually for ways in which you can, to use the word preempt competition.

"In discussions around these kinds of [119] subjects that might come up that—I think it came up that they were not familiar with those kinds of things, and we sent this kind of a letter as an example of the kind of thing that people do.

"That is a long winded answer.

"Question: In the body of the letter it uses the word blank incorporated in place of a company name?

"Answer: Yes.

"Question: Is that a standard type of code word, or is that—

"Answer: It is as good a one as any. You can use X, Y, Z company.

"Question: It was just randomly chosen as a word to fill that spot. That word is not related to the word Basic?

"Answer: It is not related to it, but I think that letter emanated from the discussion I had with the client on Basic.

"Question: But in some instances I am with, when using a code word in place of a company name, the code word is selected so that it has, for instance, the same number of letters the [120] company name has, so that they can be substituted without changing the length of a sentence, and so forth, when drafting the actual word to be used.

"Was that code word chosen in this case for something like that?

"Answer: No.

"Question: It was just chosen to fill in a space instead of a company name?

"Answer: Yes. And also because of the fact I was sending it on the telecopier machine, and I did not want to put any names of companies in there.

"Question: Is this a standard letter that would be in your file?

"Answer: No.

"Question: Or was it a letter drafted specifically for Combustion engineering?

"Answer: It is a letter drafted specifically to show an example of the kind of proposal letter we probably discussed at a meeting at Combustion Engineering."

* * * *

[128] * * * * Q. And the memo goes on to state, "Number 2, Lambert will check and get back to you—stock is off, and so is targets. He thought Basic was still at 34, not at 24-25."

Can you tell me what that refers to? A. The two sentences?

Q. Yes. A. Again, as part of the ongoing relationship and work that goes on when you're an investment banker, and you're working on analyzing a situation.

If you haven't heard anything for a while, you call up the client and say, what is doing with this, what is doing with that, and Mr. Gross was obviously, from reading this, not familiar with where the project stood and said he would get back to us and the stock is off and so is target, is basically my commenting on the market. And that is within the second sentence.

The third sentence, I have a quotron in my office, stock quotron, which is a cathode ray tube, and you can access it for stock market data.

And you are talking to a client, and you say, Lambert, your stock is off two points today, or up two.

[129] And by the by, Basic stock is off and in the course of that conversation, Mr. Gross, who you will recall was not enamored with the possible acquisition of Basic, thought that Basic was trading at 34 where, in reality, on or about October 24th, it must have been trading in the 24 to 25 range.

Q. According to this memorandum? A. According to that memorandum.

Q. So it was actually trading below where Mr. Gross had indicated he himself thought the stock was trading? A. Right. Which I think reflects his continuing lack of interest in Basic.

Q. You mean Mr. Gross' lack of interest in Basic? A. Yes.

Q. Do you have any reason to believe that Mr. Kelly was not still interested in Basic? A. I have no idea where Mr. Kelly stood.

Q. The memo says in the upper portion, Others: Grassi. Who is Mr. Grassi? A. Tony Grassi is the managing director of First Boston. He, at the time, was assigned to the Combustion Engineering account. * * * *

Excerpts from the deposition of H. Chapman Rose
by Respondents

[71] * * * * Q. Mr. Rose, as of October 21, 1977, were you aware that Mr. Kelly of Combustion Engineering had said that Combustion Engineering was very interested in acquiring Basic? A. We went at length over this morning the extent of my awareness of Mr. Kelly's contacts with Basic. I was aware that he called on them from time to time. When you say "was very interested in Basic," I would have to say no. * * * *

[229] * * * * Q. Did Mr. Muller ask you for advice during the course of that telephone conversation? A. The only indication that he asked me for advice was as to whether in that stage of affairs there was an [230] obligation on his part to either call a Board Meeting to tell the other directors. I recall telling him I thought not because of the fact that Mr. Kelly promised to come back with an offer and we didn't have any word from Kidder-Peabody so that there was nothing of substance at that point to communicate.

Q. Did Mr. Muller tell you when Mr. Kelly would come back with an informal offer or a formal offer? A. No, as a matter of fact what ensued after that was a long silence until November.

Q. Did you know that Mr. Ludwig spoke with Mr. Kelly in September of 1978? A. Well, I think there were inquiries by Mr. Kelly as to what the hell had happened to the Basic stock. * * * *

[253] * * * * Q. I direct your attention specifically to the second paragraph of the italicized portion in the middle of the first page which says that "With regard to the stock market activity in the company's shares we remain unaware of any [254] present or pending developments which would account for the high volume of trading and price fluctuations in recent months."

Did you participate in drafting that language? A. I certainly participated in reviewing it, because I was acting as the Chairman of the Audit Committee which reviewed the third quarter report. And it had my full approval, then and now, as did the press release. * * * *

[262] * * * * BY MR. ELKIND:

Q. Mr. Rose, did you speak with Mr. Muller or Mr. Ludwig about Combustion Engineering in October or November of 1978? A. I think there were conversations, yes—October or November, did you say?

Q. Yes, do you recall what those conversations were about? A. My general impression is that I, in the light of the discussions of June and early July inquired from time to time whether anybody heard from Mr. Kelly and whether there was any progress, and that the answer was always no. * * * *

[264] * * * * Q. Did you ask Mr. Muller or Mr. Ludwig whether they had spoken with Mr. Kelly at all? A. When you rephrase these questions with slightly different nuances, I can't say that there was no communication whatever; what I can say is that my impression was or what I was told was that there had been no follow-up on the promise to produce an offer.

Q. Did you ask them why there had been no follow-up on the promise to produce an offer? A. Yes.

Q. And what did they say? A. We exchanged impressions that possibly the improvement in the stock of Basic had cooled off Mr. Kelly's interest.

Q. Did Mr.—you said we exchanged impressions. A. Yes.

Q. Who is the "we" who exchanged those impressions? A. Muller, Ludwig and I. * * * *

**Excerpts from the deposition of Arthur J. Santry, Jr.
by Respondents**

[15] Q. Was it your impression, from your discussions [16] with Mr. Kelly, that as far as he was concerned, he would acquire Basic at any point assuming Basic was interested? A. I don't think I know what that means. You know, Mr. Kelly cannot decide to acquire Basic.

He might decide to recommend it to me but that is all he could do. I mean nothing could happen unless I okayed it. * * * *

**Excerpts from the Examination of Martin A. Siegel
by the SEC**

[46] * * * * Q. Following this second meeting with Basic, what was your next contact with the company? A. Oh, in the beginning of December of 1978, I received a telephone call from Mr. Ludwig who indicated that he would like me to come out to Cleveland to meet with the company. He did not indicate to me what the subject was. In fact, I asked him what would he like to talk about and he said, we'll tell you when you get here and then, I think that was the first or second week and I think around the 13th or the 14th, that Wednesday, whenever that was, I then went out to Cleveland for a meeting with them. At that meeting, I was informed that the company had had an approach made to it by Combustion Engineering and that Combustion Engineering had indicated that at one meeting or something that they may be interested in acquiring Basic at possibly thirty-six dollars a share. They asked what my thoughts were on that and I asked, you know, whether or not they had perceived that now was the time to sell in terms of where the company going and whether or not as a corporate decision it made sense. And they had indicated to me that they

thought perhaps that now was the time to sell, that they, for various reasons, thought this would be a [47] very useful merger between the two. They thought there would be benefits in the association. And they wanted to again know if I thought the thirty-six dollars was an appropriate price. Having gone over the numbers in the files that, from the previous analyses of the company and also checking with Mr. Parker and Mr. Lowry before I left for my trip as to the current state of our understanding of the valuation of the company, I indicated to them that I thought the thirty-six dollar price was not an adequate price and that if they wanted to sell, they could certainly do much better than that. The stock at that time, I think was trading in the low to mid-twenties. They asked me what I thought a good valuation for the company would be and I said that at least forty dollars a share in terms of valuation and possibly as high as forty-five. We didn't discuss tax free versus taxable. I think there was a discussion of a desire for a tax free deal and having gone over the shareholder base again, it seemed to me that that really wasn't a prerequisite, especially with a lower capital gains rates that were available to shareholders in a cash transaction. I then suggested that we would completely update ourselves on our analysis of the company to make sure we were fully up to date, cause these again were only after a brief discussion of updates on valuation from the Corporate Finance people before I left and so I indicated that I [48] thought Mr. Parker ought to come out and make sure that he was fully up to speed on what was going on with the company and from there we would sit down and negotiate with Combustion and whoever else they wanted us to negotiate with and determine what was an appropriate course of action. That's how we left it. I then stayed over in Cleveland that night—I don't remember why; I might have had another meeting in Cleveland—and I remember getting a call at my hotel room from Bruce Waserstein (phonetic) of First Boston. Mr. Waserstein represents Combustion Engineering and he indicated that he had traced me down, calling all the hotels in Cleveland and wanted me to know that his client was very

much interested in acquiring Basic. He somehow knew of the fact that I had a meeting with Basic that day and that his client wanted to move on an expeditious basis. I indicated to him that timing was always a function of price and if he wanted to come in with a price that we didn't need much analyses on in determining if it's fair, if it's so high that it was obviously fair, then that had a tendency to make timing faster and he said that he'd get back to me. I then went on to do something else on Thursday. Then on Friday, I guess there was some unusual trading activity in the stock. The stock had started to run, by which time, the New York Stock Exchange, I think, was calling the company and asking what's going on. The company then [49] I think called up and said to stop trading because something may be coming and I went back to Cleveland—I don't remember if I went back that Friday afternoon or not till Monday, but I was certainly in communication with them, at which time I indicated that, you know, there obviously was something going on cause of the unusual trading activity in the stock and there may be some decisions that might wanted to be made on a relatively short timeframe, so I suggested that the rest of our Corporate finance team, Mr. Parker, Mr. Brown and I think it was Mr. Rogers, come out and make sure they were fully up to date on the company and its prospects and valuations, so that if we had to analyze an offer, we'd be fully qualified to do so. At the same time, Mr. Waserstein of First Boston continued to call me on this and indicating whether or not my client attitudes were such that now he was, would like to seriously consider an offer. No offer had been made; an indication of interest had been made, but no offers had been made. And I said that my client would seriously consider any indication, but the thirty-six dollar number that had been thrown out on the table was patently ridiculous. And he indicated to me, well what would it take to do a deal and I said to him, I can't tell you, you tell me what you want to offer us and, you know, we'll decide whether or not we think that offer is adequate and if it's adequate and the [50] Board approves it, then there'll be a transaction. This went back and forth for a

number of times and during that timeframe I was advising the company of my conversations, and this was over the weekend, at which time they came back and said, well, would an offer of, I think forty-two or forty-three be adequate? And I indicated at that time that I, you know, to the extent of the work that we'd done at that point, I didn't see that being a number again that I could immediately say was going to be inadequate and we'd have to do more work on it and certainly wasn't an offer that was high enough to, that become apparently obvious that it was adequate. And then, again I'm sort of remembering conversations—I remember the numbers better than I remember the exact conversations. At that point, he came back and said, forty-five, would this be an appropriate number and I said well you're starting to get up into the range of where I think, you know, we would be able to say this thing is certainly adequate, but you're going to have to do better than forty-five if you want acquiescence on the part of my client, again having advised my client throughout this. At that point they said, well, we'd like to have a meeting setup between our client, Combustion,—I forget the name of the head of Combustion—and your client and could he come out to Cleveland and meet with him and I think that was on a Monday afternoon or a Tuesday [51] morning. This was after the weekend. A meeting was held. In addition, there was some work being done on stock options and making sure that the officers and employees of the company would be adequately taken care of vis-a-vis any incentive compensation programs that they had had, and discussions of employment contracts was also determined. Combustion did come out. They made an offer of forty-six dollars a share, better than forty-five, and indicated at that time, although no formal arrangements would be made, they would make sure that the employees would be adequately taken care of in terms of either options and things like that. At that time, we had been working through the weekend to perform our analysis. We determined that the forty-six dollars a share was certainly an adequate price and a fair price for the shareholders. We so advised the Board of Directors of Basic, Inc. on that Monday or Tuesday afternoon. Subsequently, the deal was announced and the tender offer procedure and the acquisition was consummated. • • •

**Excerpts from the deposition of William Steinbrink
by Respondents**

[43] * * * * Q. Do you recall what occurred in the conference on September 25th of 1978? A. Yes, in part.

Q. Would you tell me what you recall of that conference? A. I recall that Chappy Rose contacted me in the middle of the day and told me that, as I recall, there had been an inquiry from the New York Stock Exchange about activity in Basic stock, that either they had been requested to or they were going to issue a press release, and he asked if I would meet with Matt Ludwig and with Davis Young with respect to the preparation of that press release.

Matt came to my office. We talked for awhile. We were later joined by Davis Young, [44] who brought with him a draft or a version of the press release. We talked about what the situation was, what the press release ought to say.

We concluded that, although the people there, really Matt, were satisfied with what the press release said, but that it would be appropriate to check with Muller because the press release was saying that management is unaware of any present or pending company development.

My recollection is that Max Muller had been out of the country for some period of time, a week or two or whatever it was. Matt Ludwig was especially concerned that Max might know something that Matt didn't know.

So we placed a call to where we thought we would find Max. We did not find him there, but my recollection is that he was found and did call us back sometime later that day and confirmed that he was not aware of any present or pending company developments that would bear on the trading activity.

Q. Did you, prior to or after your telephone conference with Mr. Muller, inquire of Mr. [45] Ludwig as to whether he had any knowledge of any company developments? A. Yes, I believe we talked at some length about what was going on that might give rise to the trading activity at the moment. There were two possibilities that we identified.

One was that Basic simply was having a very good year financially. Their earnings had been up considerably during the course of the year, that fact was known, the results for the first half had been previously announced, and things simply were looking very good for the company from that perspective.

The second factor of which we were aware was that there was a general phenomenon at this point in time in which a lot of issues traded on the New York Stock Exchange and other markets were jumping up and down based upon investors' guesses, assumptions, whatever, that a takeover was going to occur. These market swings would heat up for a few days and then nothing would come of it and they'd die down and go away.

That activity seemed to be very heavy, in [46] other words, there seemed to be a lot of it at this point in time with many different companies, and it seemed to us that Basic was being affected by that type of trading activity. * * * *

[53] Q. In your discussions on September 25th, [54] 1978 with Mr. Muller, your telephone conference, he did not raise the subject of Combustion Engineering? A. I do not recall whether or not Mr. Muller raised that subject. I believe I was aware that there had been discussions with Combustion Engineering. Whether I was told that by Chappy Rose or Matt Ludwig or Max Muller, I really have no recollection. But I do believe I was aware that those discussions had occurred sometime in the past.

I also believe that I understood that those discussions had terminated or aborted or been unfruitful or whatever. In any event, I believe I understood that they were not continuing at that time.

Q. From what source did you get that understanding, if you recall? A. I really don't recall. I have some vague feeling that Chappy Rose may have explained that to me when he initially contacted me that afternoon, and I have a further vague recollection of having discussed it with Matt when we were working on the press release. * * * *

**Excerpts from the deposition of Carl Steinhouse
by Respondents**

[12] * * * * Q. Can you tell me what it was that you were involved with in regard to the representation of Basic in June of 1978? A. I was involved with the consideration of anti-trust problems with respect to, the best I can remember it, Basic's desire to acquire a division of Combustion Engineering.

Q. That was the refractories division of Combustion Engineering? A. I believe so, yes.

[13] * * * * Q. Was that the extent of the work that you performed on behalf of Basic from June through December of 1978? A. As far as I know, yes.

Q. And it related solely to a possibility of Basic requiring CE's refractory division? A. As best I can recall, the June work, from June 16th through June 28th, related solely to consideration of the acquisition of the refractories division of Combustion Engineering. * * * *

[29] * * * * Q. During 1978 were you involved in any anti-trust review or analysis concerning CE's acquisition of Basic? A. I don't recall any such involvement, no. * * * *

**Excerpts from the deposition of Theodore Thomas
by Respondents**

[19] Q. Prior to December 31st, 1978 had you heard of something called the New York Stock Exchange Corporate Manual? A. I have a copy of it.

Q. You have this in your office? A. Yes.

Q. Let me ask you, Mr. Thomas, did you have a copy of the New York Stock Exchange Company Manual in your office prior to 1976? A. Yes.

Q. How long have you had a copy of it? A. My own copy, since 1966, when I was made secretary of the company.

Q. And have you read it? A. Yes.

Q. Is this a loose-leaf folder, or what form does it take? A. It's loose-leaf.

Q. It's in a binder? A. Right.

Q. And from time to time additions come in from the New York Stock Exchange? A. That's right.

Q. Changes as to what constitutes appropriate business practices come in? [20] A. Any changes in the manual.

Q. And do you put those into your manual? A. Yes.

Q. Do you read them before you put them in? A. Yes.

Q. You keep up with them? A. Yes.

Q. You said you have had a copy of the New York Stock Exchange Company Manual since the time you became secretary of the company? A. Yes.

Q. Why did you get a copy of the New York Stock Exchange Manual at that time? A. Because I was the company contact with the Exchange.

Q. Did somebody suggest that you get a copy of it? A. When I was made the company contact, they sent a copy, the Exchange did. I'm sure my predecessor had a copy of his own. This was my own copy.

Q. Have you referred to this manual from time to time? A. Yes, I have.

[21] * * * * Q. Prior to December 31st, 1978 did you refer to the New York Stock Exchange Company Manual from time to time? A. Yes.

Q. For what purpose? A. For whatever question came up.

Q. For guidance? A. Yes.

Q. For guidance as to what constituted good business practice? A. Or had to do with issuing additional shares and fees.

Q. Public disclosure? A. Various matters.

Q. Questions as to the form of public disclosures? A. I've seen the manual in that regard, yes.

Q. And did you try to follow the manual in that regard? A. Yes.

Q. Now, when the question of public disclosure came up, was it your understanding [22] that you ought to look to the

New York Stock Exchange Company Manual for guidance as to what constituted appropriate public disclosure in a particular instance? A. I looked into that manual. If anything deeper than that was involved, I would report it to my superior, who would then consult with counsel about it, because I did not make the determinations.

Q. Well, at this point all I'm asking you for is what you looked to when it came time for you to determine what kind of a public statement ought to be issued. A. I did not make that determination. I referred it to my superior.

Q. Did you draft public statements? A. No.

Q. Did you participate in drafting public statements? A. Oh, I reviewed them.

Q. Were you ever present when a public statement was being drafted? A. I was present in the drafting or reviewing process. * * * *

[97] * * * * Q. Did you have a meeting about this particular quarterly report? A. I do recall we discussed it.

Q. Who was the we; who discussed it? A. Muller, Ludwig, Collins and myself.

Q. Do you recall, was there a meeting? A. I don't recall if there was a formal meeting or just an offhand discussion about it.

Q. Were you all together when you discussed it? A. We may have all been together, we may not have. I don't recall any special meeting for the purpose.

Q. You do recall that you, Muller, Ludwig and Collins discussed this particular quarterly report.

Who suggested that you discuss this particular quarterly report; whose idea was it? A. I have no idea. These things are [98] frequently just spontaneous.

Q. Did you determine that you wanted to discuss this quarterly report? A. I have no idea who made what determination.

Q. Did Mr. Muller want to discuss this quarterly report? A. I can only repeat, I have no idea of the sequence of events.

Q. Did Mr. Collins say that he wanted to discuss this quarterly report? A. I can just repeat my prior answer.

Q. Well, somebody must have wanted to discuss it.

Do you know who that was? A. I do not know. * * * *

Q. How long did you discuss this quarterly report? A. I have no recollection. * * * *

[99] * * * * Q. What did you say to Collins about this quarterly report? [100] A. I don't know if I said anything directly to him or to the group or individually.

Q. Do you recall what Collins said about this quarterly report? A. No, I do not.

Q. Do you recall what you said to Mr. Muller about this quarterly report? A. No, I cannot recall.

Q. Do you recall what Mr. Ludwig said to you about the quarterly report? A. No, I do not.

Q. Even in general terms; you don't recall the general subject matter of what you he said to you or what you said to him? A. No.

Q. Do you recall what you said to Mr. Muller about this quarterly report or what he said to you? A. No, I do not recall.

Q. Even the substance; you don't recall? A. No.

Q. Do you recall what was discussed when you discussed this quarterly report? A. The only thing I do recall is just phraseology.

[101] Q. Phraseology of what? A. Of whatever the message was.

Q. Well, what message are you referring to?

It's only a two-page report. A. Well, this is the message, what we call the message (indicating). The rest is from accounting.

Q. You were pointing to the portion that appears in italics right under the heading Basic Incorporated, nine months report, 1978, is that correct; is that the portion which you discussed? A. That's right.

Q. Well, let's start from the beginning of that. It says, and I quote, "Earnings per share of \$1.32 in the third quarter and \$3.13 in the first nine months exceeded those in the like periods of last year by 16 percent and 20 percent, respectively, establishing new quarterly and nine months records."

Did you discuss that portion of the phraseology? A. We discussed whether we should use percentages or not and reiterated that it was a new quarterly and nine months record for [102] factualness.

Q. When you say you discussed whether you should use percentages, you mean whether you should use 15 and 20 percent? A. Yes.

Q. What was the discussion about that; what was it that had to be discussed? A. Generally we had tended to shy away from using percentages. We said, well, let's use them anyway.

Q. Whose idea was it to use percentages? A. I don't recall.

Q. Was someone in favor of it? A. I can't recall.

Q. Was someone against it? A. My recollection isn't that specific.

Q. What about the rest of that top paragraph; was there any discussion about the rest of it? A. Not that I know of.

Q. Was there any discussion about any earnings projections that had been prepared within Basic? A. No, none whatsoever.

Q. Do you know whether earnings projections had been prepared by the date of this report [103] to shareholders? A. We always have projections. It's a constant process.

Q. Do you know whether earnings projections had been given to Combustion Engineering prior to the date of this report to shareholders? A. As of this date, I do not know.

Q. Now, let's look at the second paragraph, which says, and I quote, "With regard to the stock market activity in the company's shares, we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months."

Did you have a discussion about that portion? A. Yes, we did.

Q. What did you discuss? A. Everyone seemed to agree it was a good vehicle to communicate with the shareholders on the subject, as opposed to just any general press release, that this would get right to the shareholders.

Q. Why did you want to get right to the [104] shareholders on this particular topic? A. We have an obligation to keep our shareholders informed, I suppose.

Q. I suppose you do. * * * *

Q. Did you have a discussion about conversations that had occurred between Basic and other companies? A. No.

Q. You didn't talk about that at all? A. No.

Q. You didn't talk about it at all when you prepared this language? A. That's right.

Q. Did you know, at the time that this interim report was sent out to Basic's shareholders, that Mr. Kelly had made a dollar offer for the purchase of Basic? A. I did not know.

Q. You didn't know that? A. No. * * * *

[106] * * * * Q. How long did you talk about the language of paragraph two, this second paragraph in italics? A. I have no idea of the time.

Q. Now, you've said that you would only discuss these quarterly reports when there was something unusual about them.

Did you consider there to be something unusual about the second paragraph? A. Yes, outside of just plain earnings figures.

Q. And you said that you thought this would be a good vehicle to have an impact upon the shareholders, is that correct? A. To communicate with the shareholders.

Q. But you thought that this was a particularly suitable vehicle, rather than a press release? A. Yes, because every shareholder gets this.

Q. Well, were there reasons, in addition to the fact that every shareholder gets this, why you thought this was a particularly [107] suitable vehicle? A. No. It was purely as a

means of communicating with the shareholders, to make sure that everyone got the same message.

Q. Now, why did you want to make sure that everybody got the same message; was it because of the activity in Basic stock? A. Yes.

Q. Was it because there had been rumors of possible merger negotiations between Basic and other companies? A. Just because of the activity in the stock, and some shareholders called in inquiring about the activity, and this is a good way to answer all of them.

Q. Had shareholders called in and asked whether there were merger negotiations? A. They called to ask about the activity in the stock. Now, they might have mentioned a merger. I don't know.

Q. Well, do you recall whether shareholder asked you whether there had been merger negotiations? A. I don't recall.

Q. Did they ask any other officers or [108] employees of Basic? A. I don't know what they asked other officers or employees.

Q. Now, you said that one of the reasons for this language was the activity in Basic stock.

By activity, do you mean to include the volume of trading in Basic stock? A. Volume and price movement.

Q. What do you mean by price movement?

The price had been going up. A. It fluctuated.

Q. Had the price gone up? A. From when to when?

Q. Well, had there been a price rise shortly before the issuance of this report to shareholders? A. I don't have my records with me, so I can't tell.

Q. Mr. Thomas, you referred to the price fluctuation in Basic stock.

Can you tell me what you mean by that? A. Well, the changes in prices and the volume of trading. * * * *

[147] * * * * MR. STERNMAN: Are you asking him to assume there was such an offer made?

Q. Did anybody tell you that Mr. Kelly had asked Mr. Ludwig or Mr. Muller whether they would accept \$28 per share for the stock of Basic? A. No.

Q. Did anybody tell you that Mr. Kelly had said to Mr. Muller, are you ready to merge with Combustion? A. No.

Q. Did anybody tell you that Mr. Kelly had said to Mr. Muller that he advised against public disclosure? A. No.

Q. Had anybody told you that Mr. Kelly was very anxious or had said that he was very anxious to merge with Basic? A. No.

Q. Were you kept up to date on the discussions between Basic and Combustion, Mr. Thomas? A. No.

[148] Q. Now, you testified before, I believe, that you were responsible for responding to inquiries from brokers and from shareholders, is that correct? A. Yes.

Q. Did brokers or shareholders ever ask you whether there were pending corporate developments? A. That was generally the tone of the questions.

Q. Did they ask you whether there was a pending merger or whether there were merger discussions? A. In a general way, not specifically.

Q. Did you respond to those inquiries? A. Yes.

Q. Will you please tell me how you responded to those inquiries if you didn't know what those discussions were and weren't kept up to date? A. Muller, Ludwig and myself had periodic discussions, as the stock activity kept changing, as to, does anyone know what is causing the stock activity, and the answer was no.

[149] Q. Did you ever ask him whether Combustion was anxious to merge with Basic? A. I did not ask him. I did not know the status of the Combustion Engineering discussions.

Q. Did you ever ask them or did they ever tell you whether Combustion was ready to make an offer? * * * *

[150] * * * * A. I had no reason to believe there was anything serious with Combustion.

Q. That was because nobody told you, right? A. That's right.

Q. Did you ever suggest to Mr. Muller or Mr. Ludwig that, in light of their greater familiarity with discussions between Basic and Combustion, perhaps they should have been the persons who would respond to questions from brokers or shareholders? A. There was no inkling in my mind that Combustion Engineering was—

MR. STERNMAN: That's not the question, Mr. Thomas. The question is did you ever suggest to Mr. Muller and Mr. Ludwig that, in view of their greater command of certain facts, they should be the ones to respond to inquiries.

A. No.

Q. Did you ever ask Mr. Muller or Mr. Ludwig to bring you up to date on the discussions between Basic and Combustion? A. No. * * * *

[156] action of a corporation's securities should be closely watched at a time when consideration is being given to significant corporate matters. If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required. If rumors are in fact false or inaccurate, they should be promptly denied or clarified. A statement to the effect that the company knows of no corporate developments to account for the unusual market activity can have a salutary effect. It is obvious that if such a public statement of this sort was contemplated, all levels of management should be checked prior to any public comment so as to avoid any embarrassment or potential criticism. If rumors are correct or there are developments, an immediate, candid statement to the public as to the state of negotiations or the state of development of corporate plans in the rumored area must be made directly and openly. Such statements are essential despite the business inconvenience which may be caused [157] and even though the matter may not as yet have been presented to the company's board of directors for consideration."

I show you the language. A. Yes.

Q. Mr. Thomas, had you read that portion of the New York Stock Exchange Company Manual? A. Yes.

Q. You were aware of it? A. Yes.

Q. Now, had you had occasion to apply that portion of the New York Stock Exchange Corporate Manual before to contemplated releases or public statements? A. Well, this Flintkote news release or Flintkote article was one. Whenever I had contact with the New York Stock Exchange, I explained to them of the rumors that we had heard.

Q. Well, let's take the Combustion discussions. A. I never heard a rumor about Combustion.

Q. Had you heard rumors, generalized rumors, about a possible merger involving Basic? A. Oh, yes.

[160] * * * * Q. Do you know whether, prior to the issuance of the quarterly report for the third quarter of 1978, an effort was made to determine whether there had been leaks of the discussions between Basic and Combustion?

MR. STERNMAN: I'm going to let him answer the question, but it's the same question you asked before. Go ahead and answer.

A. I do not know whether any efforts were made, nor how they would have been made.

Q. But you were familiar with this directive of the New York Stock Exchange Company Manual.

Did you ask Mr. Muller or Mr. Ludwig whether they had made any attempts to determine whether there were leaks?

A. That was not for me to determine.

MR. STERNMAN: That's not the question. Did you ask them?

Whether it was for you to determine or not, did you ask them, yes or no?

THE WITNESS: No.

[169] Q. What do you mean, you had been through that already; you mean you had discussed that before? A. It was a constant process throughout the year.

Q. You mean discussion about the reasons for the trading activity? A. Right.

Q. When you say it was a constant discussion, do you mean it was a topic that people brought up from time to time? A. Yes, if anyone had heard a new rumor or what have you, they would circulate it.

Q. What kind of rumors did you hear? A. About potential mergers, that someone says, I hear you're a potential merger candidate, that sort of thing.

Q. Well, how often did you hear these rumors? A. I can't give you any time frequency, just from time to time, when brokers would call. * * * *

[170] * * * * Q. In 1978 did you get a lot of calls from brokers who told you that they were hearing merger rumors?

MR. MADSEN: Object to the form of the question.

MR. STERNMAN: What do you mean by a lot; ten a month, five a month?

Q. Did you get more than ten calls from brokers? A. In periods of high activity we had more than ten.

Q. How many? A. In any one particular day, it could be one to ten, 15.

Q. In one day? A. Yes.

Q. You mean there were days when you got 15 telephone calls from brokers who said that they were hearing merger rumors? A. Yes, or asking if we knew anything as to why the stock was so active.

[171] Q. Were there any other meetings, other than the two meetings you've referred to, at which this nine month quarterly report was discussed prior to its issuance? A. I don't know for sure. I think an interpretation of a meeting needs clarification.

If I bumped into Muller or Ludwig in the hallway and made a remark, is that a meeting?

Q. Well, let me rephrase the question.

Do you recall discussing this quarterly report with Mr. Muller, Mr. Ludwig or anybody else prior to its issuance? A. Yes.

Q. Well, tell me what that discussion was. A. The same discussion that I've been telling you about.

Q. Well, I mean, other than the two meetings that we've already discussed, did you have any additional discussions with anybody about this quarterly report? A. With anybody other than these people we're talking about?

Q. Well, let's start with that.

Did you discuss it with anybody other [172] than Muller, Ludwig and Collins? A. Not to my recollection. Those are the only people that are involved.

Q. Other than the two meetings that we have already discussed, did you have any further discussions with Mr. Muller, Mr. Ludwig or Mr. Collins about this quarterly report prior to its issuance? A. We may very well have had some casual—

MR. STERNMAN: Do you recall any?

THE WITNESS: Not specifically.

MR. STERNMAN: Do you recall any?

THE WITNESS: No.

Q. Did Mr. Muller or Mr. Ludwig or Mr. Collins, to the best of your knowledge, discuss this quarterly report with anybody else before it was issued? A. To my knowledge, it was discussed with counsel.

Q. Other than counsel. A. Not to my knowledge.

Q. Was it brought to the attention of the [173] board, the board of directors of Basic? A. Oh, the audit committee of the board of directors passed on it.

Q. When you say the audit committee of the board of directors passed on it, what do you mean; do you mean that they reviewed it when it was issued? A. Yes.

MR. ELKIND: I'd like to have the reporter mark as Plaintiff's Exhibit 67 a copy of a document that's been numbered B-S-15. This is a document which has been produced by Basic, and it appears to be minutes of the audit committee meeting dated November 1, 1978.

(Thomas Deposition Exhibit 67 was mark'd for purposes of identification.)

Q. Do you have Plaintiff's Exhibit 67 before you, Mr. Thomas? A. Yes.

Q. How frequently did the audit committee of Basic meet? [174] A. At least quarterly, to approve the releases of this type.

Q. They regularly met to approve quarterly statements to shareholders? A. Right, and the annual report as well.

Q. Were you present at the audit committee meeting on November 1st, 1978? A. No.

Q. Who were the members of the audit committee? A. The members are Mr. Rose, Mr. Wilson and Mr. Gelbach, and I believe Mr. Sylvester was an alternate.

Q. You said Mr. Gelbach? A. Yes. Mr. Gelbach was chairman of the committee.

Q. Was he chairman of the committee at this time, at the time of this meeting? A. Yes. Mr. Rose was acting chairman in Mr. Gelbach's absence. * * * *

[175] * * * * Q. Do you know who prepared these audit committee minutes? * * * *

THE WITNESS: No.

Q. Mr. Ludwig was not a member of the audit committee, is that correct? A. That is correct.

Q. Was it his practice to attend audit committee meetings? [176] A. He would attend them. At times he would be excused, for certain portions of them.

Q. What about Mr. Arnolt; he wasn't a member of the audit committee either, was he? A. No.

Q. Would he, as a matter of course, attend audit committee meetings? A. Yes, because he was the provider of the figures.

Q. Could you identify him, please? A. He's a partner in Ernst & Ernst, now Ernst & Whinney. The practice has been for Arnolt and a member of the CPA firm to attend the meeting.

Q. And Ernst & Ernst at this time were your outside accountants? A. Yes. * * * *

[177] * * * * Q. Now, the second paragraph of Plaintiff's Exhibit 67 says, and I quote, reading from a portion of it, "Mr. Rose suggested a few minor changes with respect to the text of the management's discussion and analysis of the results of operations and the president's comments. The other committee members agreed with these suggestions, and the committee indicated that the interim report as so modified could be printed and released."

Do you see that? A. Yes.

Q. Do you know what changes Mr. Rose suggested? A. No, I do not.

Q. Nobody has told you? A. No.

Q. Had anybody told you what was discussed at the audit committee meeting, this audit committee meeting? A. No one specifically told me.

Q. Was there a procedure by which Mr. Ludwig, [178] or anybody else for that matter, would bring you or other persons at Basic up to date as to what went on at audit committee meetings? A. No, unless there was some significant reason for him to do so. Not as a routine matter.

Q. Did anybody tell you what changes were made in the president's message of the quarterly report for the nine months ending September 1978 as the result of the audit committee meeting? A. I don't recall that they did. If they did, I don't remember what changes there were.

Q. Do you have any recollection of what the changes were that were made at any time after the preparation of the initial draft of the president's message in this interim report? A. I can't recall any changes.

Q. You don't recall specifically what they were? A. No, that's right.

Q. Do you recall what they related to? A. My recollection is that the main idea was not changed, just a matter of words here and there. * * * *

[214] Q. What brokers did they get this feedback from? A. I don't know. Any number of them.

Q. Did they ask brokers to find out who was doing the buying of Basic stock? A. I don't know whether they asked or whether it was volunteered.

Q. Now, how do you know that Mr. Muller and Mr. Ludwig were concerned about the possibility of a hostile tender offer?

MR. MADSEN: Object to the form of the question.

Q. Did they tell you? A. Well, yes, in our discussions.

Q. When is the first time they told you that? A. I couldn't remember.

Q. Was it in 1976? A. It was probably well before then, but I can't give you a definite date when they first—every chief executive is concerned—* * * *

[215] * * * * Q. Did there come a time when Mr. Muller was particularly concerned about the accumulation of Basic shares?

MR. MADSEN: Objection.

MR. LORENCE: Objection to the form. You may answer, sir.

A. There is no particular time that I can [216] recall.

Q. He was just generally concerned throughout the period? A. Yes.

Q. And Mr. Ludwig was also concerned throughout the period?

MR. MADSEN: Object to the form.

A. Yes.

[253] * * * * MR. LORENCE: David, was your question about 1977 only?

MR. ELKIND: I'm starting with 1977.

Q. Mr. Thomas, based upon your review of these documents, can you tell me during what periods it was in 1977 that you were receiving 15 calls a day from stock brokers and shareholders about merger rumors involving Basic?

MR. LORENCE: Objection to the form. You may answer, sir.

A. They were during periods of high trading activity. In 1977, this occurred about March of 1977, May of 1977—

MR. MADSEN: May I ask the witness if he is now presently recalling that he did receive that number of calls in these periods, or are you merely inferring?

In other words, is your recollection now refreshed, from looking at those documents, as to when you received this number of calls, or are you just inferring that that is when [254] you received them, based on what you're looking at in the way of exhibits?

THE WITNESS: My recollection is that I did receive these calls during periods of extremely high activity in the stock. I am refreshing my memory as to the periods by reference to these documents.

MR. LORENCE: And, in particular, you have in front of you Exhibit 70, is that right, sir?

THE WITNESS: That's right.

Q. Were there any other periods in 1977 in which you recall receiving 15 calls a day from stock brokers and investors who wanted to know about merger rumors involving Basic?

MR. LORENCE: Objection to the form. You may answer, sir.

A. Yes. The September/October period of 1977 would be another period.

Do you want to go on to 1978?

Q. Why don't we stick with 1977 for the moment? A. All right.

Q. Now, you characterized March of 1977, May of 1977, September of 1977 and October of [255] 1977 as periods during which there was extremely high trading activity in Basic stock? A. That is correct. * * * *

[258] Q. Mr. Thomas, my question to you was, in your view, were the periods March 1977, May 1977, September 1977 and October 1977 periods of unusual trading activity in Basic stock?

MR. LORENCE: I object to the form of the question because it assumes a predicate which is not in evidence in the case as to, namely, his definition of unusual trading activity.

Until you ask him the question of what, in his view, is unusual trading activity with respect to Basic stock, I am going to object and direct him not to answer.

MR. ELKIND: You're going to direct him not to answer?

MR. LORENCE: That's right.

MR. ELKIND: He himself already used the term unusual trading activity.

Q. Mr. Thomas, do you have an understanding of the term unusual trading activity? A. Yes.

Q. What is your understanding of the term unusual trading activity? A. When the normal trading activity is two [259] to four thousand shares a day, and all of a sudden it jumps to ten, twenty or thirty thousand shares a day, that is unusual, in my view.

MR. ELKIND: Very good. It was clear enough to me, and I think now we know it was clear enough to you.

Q. Were the periods March 1977 and October 1977 periods of unusual trading activity, in your view? A. In my view, they were.

Q. And were they periods of extremely high volume of trading, unusual volume of trading in Basic stock?

MR. MADSEN: Object to the form of the question.

MR. LORENCE: You may answer, sir.

A. That is the same as the prior answer. That is a criteria of what is unusual trading activity, in my view. * * * *

[262] * * * * Q. Were the periods March 1977, May 1977, September 1977 and October 1977 periods during which you were receiving 15 or more calls a day from brokers and investors who were telling you that they were hearing merger rumors? A. I think my testimony was more in the vein of from one to 15 calls a day, and that the calls had to do with questions of whether there were any unusual company activities or mergers, rumors to account for the thing.

Q. Were the brokers and shareholders telling you that they were hearing rumors of possible merger activity? A. Some were, some were merely inquiring whether there were any.

Q. Did they tell you why they were inquiring? A. No. Well, obviously, the reason was because of the activity in the stock.

[263] Q. Now, you testified yesterday, I believe, that there were periods when you were receiving as many as 15 calls a day? A. Yes.

Q. Is that correct? A. That is correct.

Q. To the best of your recollection, when were those periods when you were receiving as many as 15 calls a day? A. During periods of high activity in the stock.

Q. During the periods March 1977, May 1977, September 1977 and October 1977? A. Yes.

Q. Now, during other periods of the year did you also

receive calls from brokers or shareholders asking about possible merger activity?

MR. MADSEN: Is your question directed to 1977?

MR. ELKIND: 1977.

MR. MADSEN: Thank you.

A. I received occasional calls all the time, not specifically directed towards merger activities, but any variety of questions.

[264] Q. Now, during the periods in 1977 in which you were receiving as many as 15 calls a day, did the brokers or the shareholders that called you tell you that they had heard rumors about specific companies with which Basic might be involved in a merger? A. Occasionally, yes. * * * *

[265] * * * * Q. This is 1977 that I'm referring to. A. I'm afraid I can't, with full clarity, differentiate between 1977 and 1978. The time frame was just not fixed in my mind.

Q. Let me rephrase the question.

What were the companies that were identified by brokers and stockholders, during the period 1977 and 1978, as being involved in merger rumors relating to Basic?

MR. MADSEN: We join in Mr. Lorence's prior objection.

A. Well, one of them was Flintkote, but [266] most of them were unidentified. There were Swiss companies, generally, Belgian companies, English companies, domestic companies.

I think Hanna Mining Company was one that was mentioned.

MR. MADSEN: You said you think. Do you presently recall that that was mentioned?

THE WITNESS: Yes, that is one that was mentioned in telephone conversations.

A. I can't recall specifically other companies that were

mentioned by the telephone calls versus other areas that might have rumor foundations.

Q. What do you mean when you say versus other areas that might have rumor foundations? A. Well, whether I heard mention of other company names from other officials of Basic or whether I heard them directly from telephone conversations with brokers or shareholders.

MR. LORENCE: Let the record show a continuing objection, for the reasons previously stated, as to any [267] communications or contacts or rumors with respect to companies other than Combustion.

MR. ELKIND: Could you read the answer to the question back to me please?

(Record read.)

Q. What were the Swiss companies that were mentioned? A. They were unnamed.

Q. Did anybody suggest any names to you? A. No.

Q. What about the Belgian companies? A. No.

Q. None of the Belgian companies were identified? A. No.

Q. Was there speculation within Basic as to what the Swiss companies might be? * * * *

[268] Q. Was there speculation within the company as to who the Belgian companies were?

MR. LORENCE: Same objection. Same instruction. You are instructed not to answer, sir.

Q. What were the English companies? A. Again, I cannot identify whether I heard this internally or by the telephone conversations with brokers, but one of the companies was Hepworth.

Q. Hepworth? A. Yes.

Q. What were the other English companies that were involved?

MR. LORENCE: Again, sir, your answer should be limited to what you can recall of the telephone inquiries from shareholders or brokers.

A. To my recollection, there were not other English companies in that vein.

Q. In what business is Hepworth engaged? A. In the refractories business.

Q. Was it engaged in the refractories business in 1977 and 1978? A. Yes.

[269] Q. Now, you said that domestic companies were identified in these telephone calls.

Can you tell me what those domestic companies were?

MR. LORENCE: Objection to the form. You may answer, sir.

A. I said the domestic companies were unidentified except, to my recollection, those two that I did mention.

Q. You said that Hanna Mining was one of the companies that you believe was identified? A. Yes.

Q. What is the other domestic company that you recall presently? A. Flintkote.

Q. Do you recall any other domestic companies that were mentioned? A. I do not recall any others. There were others, but my memory just escapes me.

Q. Was TRW mentioned? A. I heard TRW, but again, I can't associate it with a call a the broker or shareholder or whether I heard TRW from some other source.

Q. From a source inside the company? A. Yes.

[270] Q. What about Diamond Shamrock; was that a company that was mentioned? A. Again, they were mentioned, but I can't identify the source of the mention.

Q. What about United States Gypsum; is that a company that was mentioned?

MR. MADSEN: Continuing objection.

MR. LORENCE: Yes. Let the record note our continuing objection and the instruction to the witness to respond to the question only with respect to particular companies that may have been mentioned to you in inquiries over the telephone from shareholders and brokers.

A. In that respect, U.S. Gypsum was not mentioned.

Q. Was U.S. Gypsum mentioned by anybody inside of the company?

MR. LORENCE: Same objection. Same instruction. The witness is instructed not to answer.

[309] * * * * Q. What were those periods in 1978? A. During the first half of 1978, there were periods within the first four months of unusually high activity. In the second half of 1978, there were periods in July, September, October and December.

Q. Now, during this entire period of time, did you have any discussion with Mr. Muller about whether it might be appropriate for the company to make disclosure of its negotiations or discussions with other companies?

MR. MADSEN: Objection.

MR. LORENCE: Objection to the form and to the use of the term negotiations and, for the same reasons we've heretofore objected, the witness is instructed not to answer. * * * *

**Excerpts from the deposition of John C. Wilson
by the Respondents**

[8] Q. Do you recall the topic of interest being shown by Combustion or other companies coming up at a board meeting in 1977? A. Not at a board meeting. No, I do not.

Q. I show you a document that's previously been marked as Plaintiff's Exhibit No. 85, which is a series of handwritten—let me withdraw that.

Let me have the reporter mark as Plaintiff's Exhibit 129.

(Plaintiff's Exhibit No. 129 marked for identification.)

BY MR. CROSS:

Q. This Plaintiff's Exhibit 129 is with a document produced Wilson-12, and it has Max PH/77. Mr. Wilson, do you recognize that document? A. Yes, sir.

Q. Can you tell me what it is? A. It's a—a sketchy list of notes that I took during a phone conversation with Max on June 28 of '77.

Q. Are these notes of the conversation you were testifying about earlier, or was this a subsequent conversation? A. It seems to me the first time Combustion Engineering was mentioned I didn't know anything about the company. I asked Max a little bit about it. He explained it, and put that down there.

MR. MADSEN: I think the question was, [9] Mr. Wilson, was whether— Could we have the question repeated?

BY MR. CROSS:

Q. All right. You testified a couple of minutes ago that the first time that you recall about learning that Combustion Engineering was interested in Basic was in a telephone conversation sometime in mid 1977 from Mr. Muller? A. Right.

Q. My question is are these notes of that conversation, or was that conversation that you testified to earlier than this June 28 conversation? A. I believe these are the notes of that conversation.

Q. Oh, all right. Can you describe for us as best you recollect what Mr. Muller said to you and what you said to him in that conversation?

MR. MADSEN: Do you want him to respond to your question without looking at the document?

MR. CROSS: For the time being.

THE WITNESS: Well, first of all, in that conversation there were other matters. This wasn't the entire amount of—of the entire substance of the telephone call or the conversation. He mentioned Combustion Engineering. Either he advised me voluntarily or I asked him what was Combustion [10] Engineering. I believe he told me it was a \$500 million company. He explained that they had a position in the refractory field, not entirely competitive with Basic, which would be a reason for their interest. Those are the principal things I remember from the conversation, that the interest of the contact was a friendly one because of understandably the two companies being in a similar business. I believe Max felt and conveyed that to me one way or another. But it was an interesting—among the people who had showed an interest, an interesting type of company but that there also quite likely might be an antitrust or conflict of interest problem if the discussions were carried any further.

Q. What if anything did you say to him? A. I just listened and made what notes you have, and which obviously were sketchy and weren't complete. It was a routine type of report by him on that and some other matters of that time.

Q. You mentioned that among the various companies that

had expressed interest in acquiring Basic, this one might be an interesting fit. Do you recall when you became aware that other companies were expressing an interest in Basic? A. You mean over what time period now?

[11] Q. Late '76-'77. A. Well, I don't recall any specific ones at this time. We were— We discussed possible acquisitions of Basic. I mean Basic as well as friendly interests or other kind of interests of other companies. I don't remember any others right at that time that might have expressed any interest in Engineering with Basic.

Q. Let me turn your attention back to Plaintiff's Exhibit 129. There is an entry at the bottom of that page which describes something about U.S. Gipson. Was that part of the same phone conversation with Mr. Muller? A. Yes.

Q. Can you tell me what you recall about that conversation? A. I have forgotten much of that conversation because it never came up again. Obviously, I at that time made the notes of a possible joint venture, but apparently—

MR. STERNMAN: I think the record should show the witness is reading from the document. At this point I think the question is what do you recall other than.

THE WITNESS: I don't recall. Let's put it this way. At the time I wrote that undoubtedly I had some reason to doing it. But since then, I don't remember since.

[12] BY MR. CROSS:

Q. It's something that Mr. Muller brought up during that conversation? A. Right.

Q. Do you recall Mr. Muller calling before this about possible acquisitions of Basic on the telephone? A. Other acquisitions?

Q. Yes. Prior to this telephone call.

MR. MADSEN: Possible acquisition of Basic by other companies?

MR. CROSS: By other companies.

THE WITNESS: No. We were—

MR. MADSEN: I think you've answered the question. If you don't recall, say so.

THE WITNESS: No, I don't.

BY MR. CROSS:

Q. This is the first conversation—telephone conversation that you recall Mr. Muller informing you that there had been an interest in acquiring Basic by some other company? A. In that time period. There may have been many before; '75, '74, '73.

Q. But not '76-'77? A. But in that time period that's the only one that I can recall.

[13] Q. Do you recall—I'll withdraw that.

Do you recall discussing the interest of any company in acquiring Basic with Mr. Muller in person at any time prior to this June 28, 1977 conversation? A. In person with Mr. Muller?

Q. Yes. A. No.

Q. This is the first time that you recall in that time frame '76-'77— A. Right.

Q. Mr. Muller discussing with you the possibility of an acquisition of Basic? A. Correct.

Q. Do you recall having such a discussion whether in person or on the telephone with anyone else associated with Basic during this time frame? A. No.

Q. Following this conversation in June—on June 28, 1977, what is the next time that you remember discussing Combustion's interest in Basic with anyone at Basic?

MR. MADSEN: I think perhaps your question—

THE WITNESS: This was—

MR. MADSEN: Just a moment, Mr. Wilson. I think perhaps your question is a little bit unclear from the sake of discussing with anyone at Basic. I don't [14] think it's

clear from your question whether you're inquiring about telephone calls or personal meetings or—

BY MR. CROSS:

Q. Do you recall discussing the subject of Combustion Engineering's interest in Basic with anyone affiliated with Basic following this telephone conversation during the course of 1977? A. I don't recall any.

Q. Do you recall the topic coming up at a board meeting? A. I don't recall it. I— It was the kind of thing that occasionally would come up at board meetings. In fact Max would report on it, but I don't recall any conversations or it coming up in this time period at any other time in a board meeting.

Q. Well, do you recall it coming up at any other context, telephone conversations, person-to-person meetings? A. The subject of Combustion acquiring Basic?

Q. Right. A. No.

Q. Do you recall some other subject about Combustion Engineering coming up? A. I do. I don't remember exactly the time period, but at one point I recall there was some discussion about the possibility of some exploration with respect to [15] the possibility of Basic acquiring the refractory division of Combustion which got nowhere. But there had been discussions of it.

Q. On Plaintiff's Exhibit 129 there is a reference in the entry for Combustion Engineering next to the last line. It says, "Merger offer for Basic." Do you recall what there was about your conversation with Mr. Muller that you were summarizing by that statement?

MR. MADSEN: Object to the form of the question. I don't think—don't think it's clear what that entry was. I have no objection to your inquiring what that entry meant, but I don't know that the witness has said that he was summarizing what Mr. Muller said.

BY MR. CROSS:

Q. All right. What do you mean by that entry? A. Well, I don't recall the details very frankly. To the best of my memory, at the same time the Combustion Engineering thing was mentioned to me the first time which was this time I believe, it was in the context of that conversation there were—the relationship in the refractory field between the two companies and understandable, therefore, possible interest and likewise, as I remember it, a possible antitrust or conflict of interest or whatever problem which might affect any [16] further discussions.

Q. Mr. Muller mentioned to you that Mr. Kelly had made a merger offer or proposed making a merger offer? A. No.

Q. Do you recall— Well, let me show you a couple of documents the reporter marked as Plaintiff's Exhibit 130, a two-page document, produced this week as BA-261, entitled, "Recent Interest in Basic" and Plaintiff's Exhibit—and bearing on Page 2 the date 1/10/77; and as Plaintiff's Exhibit 131, another two-page document used as BA-246, also entitled "Recent Interest in Basic" with a partially obliterated handwritten entry at the top that says, "Board meeting on this date—" with something written above it that isn't legible.

(Plaintiff's Exhibit Nos. 130 and 131 marked for identification.)

BY MR. CROSS:

Q. Mr. Wilson, let me show you Plaintiff's Exhibit 130 and ask you if you have ever seen that document?

MR. MADSEN: You mean other than possibly in preparation of this deposition?

MR. CROSS: Yes.

[50] * * * Q. What are the three lines below that? A. The name Jim Weeks? I can't remember anything about it, why I wrote it. Either then or since, I have never heard the name.

"Capital COM E" is obviously Combustion Engineering. "To Cleveland Monday, November 27." I don't remember what that meant. The "CE" undoubtedly is Combustion Engineering. "And 45 to 50" and those light letters after that I believe—I believe is after the "50" was a cents mark. That's the way I write cents, and I just ran it together rather than making a "C" and running a line through it, and the last word at the end I believe is "dividend", and I don't recall why I wrote that down, or what was being [51] told to me which prompted me to write that down. * * * *

EXHIBITS

[Handwritten Document]

Combustion
C-E

Nov. 3, 1966	J. Kelly visits Cleveland.
Oct. 12, 77	J. Kelly visits w. MJL, AMC, MM. Talked in general about CE & Basic.
Oct. 27, 77	J. K. tele'd: rumor that Hepworth of England may be interested in Basic. He suggested to check if some shares are held in Belgium: a) in general: b) by Mr. EMSENS (?) c) by SIBELCO. EMSENS is a director of H. Hepworth TT says no as of 9/10/77—furthermore there are only insignificant Nos. in foreign coun- tries. I related to Kelly: no shares in B.
Nov. 10, 77	MM called Kelly—told him of Morgan Stanly's part in Hepworth— Kelly asked: any you ready to merge w. Basic? MM said not yet.
Feb. 6, 1978	MM called Kelly: told him of impending visit by Peter Goodall & Derek Booth. Made date with Kelly for 2/27/78
[Page 2]	
2-27-78	10:00 to 11:30—Jim Kelly & MJL & MM met at Burke Airport. "Refr" meet'g
3-10-78	MJL AMC EPA MM reviewed financial data (3-9-78 EPA) Decision: proceed with meeting CE—Basic—as was planned for 3-13-78

3-22-78 Preston Insley, Kelly's comptroller visited Cled—all day w. MJL
EPA TT exchanged 1973-1980 figures

3-27-78 MJL AMC TT EPA MM met.
Discussed analysis.

4-3-78 MJL AMC TT EPA MM
Discussed

6-4-78 MJL AMC MM meet.

6-7-78 JK visits us in Cled—meet with MJL
AMC MM

- a) We suggest purchase of CE Ref for 11.7% i.e. \$26,000,000.
Kelly said too low
- b) Kelly indicates \$28/sh cash or stock. We say "too low"
- c) Kelly suggests _____
for CE to give us their "best figure".
MM says hold off til we "tell you"

[Page 3]

6-9-78 MM phone HCR
MM inf'd HCR of 6-7-78 meetg

6-16-78 Cled, HCR's office. MJL AMC HCR MM
Discussed results of "Kelly" meetg (6-7-78)—Outlined plan.

- a) Bring Kidder-Peabody in on an evaluation
- b) Have Steinhous—look at
CE v/s Basic + USG v/s Basic
- c) Ask CE for their "best" offer informally.

d) Update Raid-defence.
Steinbrink Kidder-Peabody

6-20-78 MM's call to Kelly re SIC Nos and market share. 1977

3297061 K says -0-
3297065 " " "
3297071 K says same

Kelly will telephone MM re above figures
Kelly suggests CE lawyers and BI lawyers to meet re FTC, since CE lawyers made thorough study. MM said yes, if J Day sees problem

6-20-78 PM: Kelly teleph'd Ss of above 3 SIC

[Page 4]

6-28-78 Carl Steinh—AMC—MM
meet—
CS says: go ahead

7-10-78 MJL—MM—AMC meet (Hermits Cl)

" MM returned Kelly's call:
Kelly will prepare an informal offer.
Advised against public disclosure. MM informs K that he'll ask Kidder Peabody for appraisal

" Tel MM—HCR: MM informed HCR of above. HCR agrees; no need to tell board yet.

7-13-78 Kelly called: he will meet with First Boston on 7-14 re Basic asked for latest figure on 1978 (said we gave him \$4,600,000. I said he should use \$5,500,000 plus

7-18 Kelly called: a) what happned to BAI stock? M.M. said: don't know Kelly asked if NYSE had called—MM said yes, merely a routine inquiry
b) Kelly asked for Basics sales 1977 by SIC Nos, all of Refr. & Chemicals. M.M. gave Kelly 3297061 . . . 65 . . . 70. MM said he will furnish the others to Kelly.

7-18: K called M: re antitrust meetg on 7-28 in N.Y. To consider a possible visit with "antitrust" in Washington (over)

[Back of page 4]

7-18 cont'd K said this would be a good time to "test" Washington
o/acct the Kaiser/Lavino case.

[Page 5]

Nov. ? Tel call from Kelly announcing a routine visit to Cld. MM says come see us.

11-27-78 J.K. visits Cld. 10:15 A.M.-845 Hanna we tell him: 1978 could easily go over \$5.00/share—Keeping below by write offs.
K said a share for share deal was out of question on/acct Basic's high trading prices. K suggests cash or 49% cash, 51% stock.
\$35.00 for cash portion.

We told K that we will ask Kidder-Peabody to assist us. K proposed

the possibility of 1st Boston (CE's banker) to meet with Kidder P. Lunch Hermit Club.
K leaves at 2 PM.

12-18-78 10:00 AM visit by Jim Kelly. MJL ACM MM—discussed details, but *not* price.

12-19-78 10:00 AM Santry & Kelly plus First Boston & lawyers.
46.00 offer; accepted

12-19- 6:30 PM. Board meeting—approved deal

[PX 5]

(Letterhead of Combustion Engineering, Stamford, Connecticut)

October 18, 1976

Mr. Max Muller, President Basic Incorporated 845 Hanna Building Cleveland, Ohio 44115	[Dear Jim—Here are the 1975 figures. Please keep confidence (only you and [remaining illegible]—Max 11/1/76]
--	--

Dear Max:

As we discussed on the telephone the other day, we would like to have a breakdown of your "Ceramic Sales", as shown in your Annual Report for 1975 in the amount of \$44,557,000.

(Note: material in brackets is handwritten.)

JA 336

The breakdown would be along the lines of the approximate breakdown which you have already given me for 1976, as follows:

<u>Product Line</u>	<u>1976 Sales</u>	<u>1975 Sales</u>
1) Refractory Brick & Shapes	\$13,000,000	[11,000,000]
2) Mortars, gunning mixes & ramming	16,000,000	[15,000,000]
3) Magnesite Grain [& Raw Magnesite]	5,000,000	[4,000,000]
4) Dolomite Grain [& Raw Dolomite]	6,000,000 [40 MM]	[6,000,000 36 MM]
5) Chemicals	12,000,000	[8,500,000]
TOTAL	\$52,000,000	\$44,557,000

Looking forward to hearing from you at an early date.

Sincerely,

/s/ Jim

JBK/k

(Note: material in brackets is handwritten.)

JA 337

[PX 7]

CE INDUSTRIAL PRODUCTS

INDUSTRIAL PRODUCTS GROUP STRATEGIC PLAN 1977 - 1983

OCTOBER 25, 1976

[REDACTED MATERIAL]

Executive Summary, Cont'd

Initiatives

The following table lists the major initiatives which have been identified and will be implemented by IPG during the planning period along with an estimate of the capital requirements for each.

Acquire Basic Inc.	\$30 million
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(Note: material in brackets is handwritten.)

[PX 8]

COMBUSTION ENGINEERING, INC.
Meeting of the Executive Committee
November 18, 1976

A meeting of the Executive Committee of Combustion Engineering, Inc. was held, pursuant to notice, at the offices of the Company, 900 Long Ridge Road, Stamford, Connecticut on Thursday, November 18, 1976 at 10:00 o'clock a.m.

PRESENT:

Messrs. W. Van Alan Clark, Jr.
Robert M. Jenney
George Putnam
Arthur J. Santry, Jr., Vice Chairman

constituting a quorum of the Committee.

Present by invitation were Messrs. James F. Calvert, Vice President-Operations of the Company, F. Gregg Bemis, Jr., Vice President-Business Development of the Company, James B. Kelly, Vice President-Industrial Products Group, Richard J. Hallinan, Secretary and General Counsel of the Company and Thomas A. Dieterich of Shearman & Sterling, Counsel to the Company.

Mr. Arthur J. Santry, Jr., Vice Chairman of the Committee presided and Mr. Richard J. Hallinan, Secretary of the Company, recorded.

The Chairman introduced the subject of the possible acquisition of Basic Refractories, Inc. ("Basic") and gave a brief description of that company. Mr. Kelly then described the business of Basic in more detail and contrasted the operations of Basic with those of the Company. He noted that, as its name implies, Basic manufactures refractories which are chemically basic, whereas the Company deals almost exclusively in alu-

mina refractories which are chemically acid, or non-basic. He explained that the Company's refractory products are based upon

Page 2

raw materials with a high proportion of alumina and silica, are used in all applications where no contact with chemically basic materials exist, and are suitable only for lower temperature applications. Mr. Kelly explained that the products of Basic, on the other hand, are based upon raw materials with a high proportion of magnesite, chrome or dolomite, are significantly more expensive to manufacture and command significantly higher prices than alumina-based refractories, are used in melt applications where contact with chemically basic materials exists, and are especially suited for high temperature applications. He stated that the Company currently mines and processes alumina raw materials, especially kyanite and mullite; that these raw materials are sold by the Company to outside customers and are used by the Company in the manufacture of alumina-based refractory specialties and alumina-based refractory brick. He reported that Basic mines and otherwise produces the raw materials used in the manufacture of basic refractories, especially magnesite (MgO) and dolomite ($CaMg(CO_3)_2$), and that these raw materials are sold by Basic to outside customers and are used by Basic in the manufacture of basic refractory specialties and basic refractory brick. He added that Basic also produces certain chemicals and electronic sub-assemblies and systems.

Mr. Kelly then described the relationship between steel production and the consumption of both alumina-based refractories and basic refractories. He summarized the Company's sales and income derived from its own alumina-based refractory products and followed this with a description of the balance sheet and cash flow of Basic and a summary of the recent sales and earnings history of its basic refractory products.

Mr. Kelly noted that the total amount of the outstanding stock of Basic, including shares subject to unexercised stock options and conversion rights of other securities, amounted to approximately 1.5 million shares. He stated that the market price of this common stock had ranged from 5-7/8 to 28-3/8 over the past

Page 3

eleven years, with the 1976 range being from 7-5/8 to 16. He advised the Committee that a purchase price of \$20.00 per share would amount to an investment of \$30,000,000; at \$23.30 per share, the investment would be \$35,000,000. He reported that a purchase price in this range would be seven to eight times the amount of Basic's 1976 earnings which were expected to be somewhat in excess of \$4,000,000. Mr. Kelly pointed out that while such earnings represented a favorable return when compared with the projected purchase price, such earnings would be a very unattractive return if compared with the cost of investing in wholly new facilities which might cost three to four times as much as the projected purchase price of Basic. He said that it would cost about \$60,000,000 for the Company to try to build a sea water magnesite plant similar to that owned by Basic, whereas the Basic facility could be expanded—if it proved desirable to do so—with a relatively small additional capital investment. He also advised the Committee that it might cost an additional \$60,000,000 to build refractory manufacturing facilities similar to those owned by Basic (in respect of which a \$10,000,000 pollution control program has been completed recently). Mr. Kelly emphasized that such high investment costs would make it economically impossible to attempt to enter the basic refractories business through the construction of new facilities, and that the only feasible way of entering the business would be to acquire existing facilities at a substantially lower price level comparable to that which appears to be available in the case of Basic. In addition, he noted that Basic seemed to be the only manufacturer of basic refractories which it might be feasible

for the Company to acquire. Mr. Kelly observed that, unless the Company were able to make such an acquisition on favorable terms, he could see no way in which the Company could attempt to enter the basic refractories business.

At the close of his presentation, Mr. Kelly noted that he personally owned 800 shares of the common stock of Basic and that if the Company were to move forward with an acquisition of that company, he would be prepared to sell

Page 4

his 800 shares of stock to the Company at today's market price of \$13.00 per share.

Following the presentation by Mr. Kelly, there was an extensive discussion of the material presented. Mr. Santry noted that he was not asking the Committee for approval to make the acquisition, but that he was advising the Committee of management's interest and activities with respect to Basic and was requesting the Committee members to make known any reservations they might have.

It was the sense of the meeting that the management of the Company should continue to proceed with its investigations, preparations and, as appropriate, negotiations with respect to the possible acquisition of Basic.

There being no further business, the meeting, upon motion, adjourned.

Secretary

[PX 144]

Monday, Jan. 10, 1977—HCR, MJL, MM

Points for discussion:

1. Expansion of the BI Board to 10 members.
Latest date for a board resolution is Feb. 4.
Suggested: Jan. 28.
ECS will be in Japan; HCL in Fla. But we may
convene a quorum without asking JAW to attend.
Retain date for regular dividend meeting, Feb. 25, with an
Audit Committee meeting scheduled for the same day.
2. Audit Committee: Consider adding MIC and compensation
to their mandate.
3. MIC awards 1976. HCR and MM are MIC committee to
consider management's recommendations.
4. Elgin - Lear Siegler
Discuss Elgin program in general.
5. Basic as a merger target. [Illegible Handwritten
Discuss present list of "Suitors". Notation]
MM desires legal guidance on management's obligations
and responsibilities.

[BA-261]

[MJL]

Recent Interest in Basic

- MM's position: Basic is not for sale, but in the shareholders' interest we should listen.
- Nov. 10, 1976: KOPPERS CO., Pittsburgh
Letter by Black Associates on behalf of Koppers.
- Oct-Nov-Dec 1976: Ted Rosenfeld, of AARON S. BRING PLANNING ASSOCIATES, New York
Rosenfeld is a cousin of our largest "outside" shareholder, Chas. Kondla. According to Rosenfeld, his firm represents foreign interests who wish to purchase all of Basic's shares. We had several telephone conversations, sent such documents as are "public", i.e., 10-K, 9 Mos., Annual Report. Rosenfeld speaks in terms of a cash offer sufficiently high to yield present owners "Book value" after taxes, i.e., about \$19.00 net. (Could mean as much as \$30.00/share). Rosenfeld will bring his principal to Cleveland on Jan. 26.
- Sept-Dec 1976: COMBUSTION ENGINEERING
Several visits by Jim Kelly, V. P. of industrial division. CE lawyers anticipate no opposition from "Anti-trust", since CE is not now in "Basic" products. Jim Kelly will visit Cleveland at 9:30 Jan. 12.
- Sept-Nov 1976: U. S. GYPSUM, Chicago
Harry Stover, President of the A. J. Green Refractory Division, visited Cleveland and made several telephone calls.

(Note: material in brackets is handwritten.)

Oct. 1976: ALCO STANDARD, Valley Forge, Pa.
Tink Veal and Mike Gelbach requested meeting. MM and MJL met with them on Oct. 28. Annual Reports, 10-K, etc., were mailed. Gelbach will visit us again to continue talks.

-2-

Nov. 1976: OGLEBAY-NORTON, Cleveland
In 1975 J. Dwyer approached MM, suggesting an exchange of 5 year forecasts. We did not pursue. In Nov. 1976 Jack Gelbach related renewed interest by Dwyer.

Oct. 1976 CROMPTON AND KNOWLES
Letter by Harry T. Whitley. MM replied that there does not appear to be a "fit".

Nov. 1976: ARTHUR P. GOULD MERGERS AND ACQUISITIONS, Chicago, claimed to be representing a financial group who is interested in acquiring for cash 100% of Basic shares and convert the company into a privately owned business. I invited him to confirm this in writing.

Nov. 1976: STEETLEY COMPANY, England.
On Dec. 16 Jack Laird and Bob Weaver visited Cleveland. Luncheon meeting: HPE, HCR, MM, Jack Laird, Bob Weaver. Laird declared Steetley's intention of a "friendly" acquisition, partial or total. He commissioned Weaver to compile figures on Basic.

M. Muller
1/10/77

[PX 13]

(Letterhead of COMBUSTION ENGINEERING, Stamford Office)

Memo to File BASIC, INC. J. B. Kelly
January 12, 1977

This morning I met with Max Muller and Matt Ludwig, President and Vice President-Finance, respectively, of Basic, Inc. at Basic's office in Cleveland.

I opened the meeting by stating that CE is very interested in Basic, Inc. as an acquisition in order to be in a position to compete with H & W, A. P. Green, General and Kaiser. We are handicapped at present by not being in the basic refractories market and being unable to enter the market from scratch as a practical alternative to acquisition. Muller and Ludwig agreed that without the acquisition of Basic, Inc. we could not be an overall competitor of H & W, A. P. Green, General and Kaiser.

I stated that Mr. Santry and I had followed the fortunes of Basic since the mid 1960's, and we would welcome an opportunity to explore acquisition in some depth with the management and directors of Basic, Inc.

I outlined our management structure and pointed out that this structure provides for a maximum amount of autonomy on the part of the acquired company management, so long as earnings progress related to markets served was acceptable and "no surprises" developed. I pointed to the Globe experience as evidence of this atmosphere.

I advised them that Basic, Inc. would report to me on an equal basis with CE Refractories and CE Minerals. I pointed out that earnings of all three were about on a par in 1976. I also advised them that existing employee benefit programs and policies would be retained in the near future unless changes were mutually agreed upon by CE and Basic, Inc. management.

I advised them that our outside attorneys have reviewed competitive conditions in the markets served by Basic and the markets served by CE and are of the view that acquisition of Basic by CE would not be violative of the antitrust laws.

I advised them that a presentation had been made to the Executive Committee of our Board of Directors and that the Committee had reviewed the facts presented and authorized continued negotiations looking toward acquisition.

Page 2

I suggested that a meeting of Mr. Santry and me with Basic top management, and subsequently with the Board of Directors of Basic, Inc. might be appropriate, in order to talk over the general question of acquisition. They were reluctant to arrange such a series of meetings as a next step, but proposed instead that they talk informally with their outside directors and if a positive response was indicated, that the two of them would come to Stamford to meet with Mr. Santry and me. I agreed.

In conclusion I stated that:

- (1) we were very serious in this approach,
- (2) we were not going to make an unfriendly tender offer,
- (3) we believed that we could offer an acquisition package that was attractive to the stockholders and met the needs of the employees in keeping Basic, Inc. competitive and viable in the basic refractories business, and
- (4) we wished to have the possible acquisitions fully explored with the management and board of directors of Basic, Inc.

During all of our discussions, I have stayed away from any price discussions.

/s/ J. B. KELLY

J. B. Kelly

JBK/cat

[PX 131A]

Recent Interest in Basic

[Illegible Handwritten Notation]
[Board meeting on this date]

MM's position: Basic is not for sale, but in the shareholders' interest we should listen.

--oo0oo--

Nov. 10, 1976: KOPPERS CO., Pittsburgh

Letter by Black Associates on behalf of Koppers. About Jan. 13, 1977 Black called MM, following up on his letter of Nov. 10, 1976. MM reprimanded him strongly for mailing a description of Basic Inc. to numerous companies (see Black's letter to CE), and that he, Black, had better stop, and that MM did not want to continue talking to someone who had taken such liberties. MM hung up.

Oct. 1976 to
Feb. 1977:

Ted Rosenfeld, of AARON S. BRING PLANNING ASSOCIATES, New York

Rosenfeld is a cousin of our largest "outside" shareholder, Chas. Kondla. According to Rosenfeld, his firm represents foreign interests who wish to purchase all of Basic's shares. We had several telephone conversations, sent such documents as are "public", i.e., 10-K, 9 Mos., Annual Report. Rosenfeld speaks in terms of a cash offer sufficiently high to yield present owners "Book value" after taxes, i.e., about \$19.00 net. (Could mean as much as \$30.00/share). Rosenfeld will bring his principal to Cleveland on Jan. 26.

MM's letter of Jan. 18 to Rosenfeld advised him to submit written concept, otherwise no

(Note: material in brackets is handwritten.)

meeting on Jan. 26. Also advised our lawyer would sit in. HCR could not make it, suggested ETK. Rosenfeld called MM on Jan. 20—MM said no written concept, no mtg.—meeting cancelled. Rosenfeld called MM on Feb. 8. MM repeated written concept, no meeting. Rosenfeld said "best forget the whole thing".

[Sept 30 77:]

[T.R. Called: [remaining illegible]]

Sep. 1976:
Still open

COMBUSTION ENGINEERING

Several visits by Jim Kelly, V.P. of industrial division. CE lawyers anticipate no opposition from "Anti-trust", CE is not now in "Basic" products. Jim Kelly visited Cleveland at 9:30 Jan. 12 reaffirming CE's interest in Basic. JK called MM on Feb. 17. JK called on May 10. MM may visit JK in July.

Sep-Nov 1976:

U.S. GYPSUM, Chicago

Harry Stover, President of the A. P. Green Refractory Division, visited Cleveland and made several telephone calls.

Page 2

Oct. 1976:
Still open

ALCO STANDARD, Valley Forge, Pa.

Tink Veal and Mike Gelbach requested meeting. MM and MJL met with them on Oct. 28. Annual Reports, 10-K, etc., were mailed. Gelbach will visit us again to continue talks. Gelbach set up meeting for 3-3-77, was cancelled.

[Sept 29, 77:]

[Illegible Handwritten Notation]

Nov. 1976:

OGLEBAY-NORTON, Cleveland

In 1975 J. Dwyer approached MM, suggesting an exchange of 5 year forecasts. We did

(Note: material in brackets is handwritten.)

not pursue. In Nov. 1976 Jack Gelbach related renewed interest by Dwyer.

Oct. 1976:

CROMPTON AND KNOWLES

Closed

Letter by Harry T. Whitley. MM replied that there does not appear to be a "fit".

Nov. 1976:

ARTHUR P. GOULD MERGERS AND ACQUISITIONS, Chicago, claimed to be representing a financial group who is interested in acquiring for cash 100% of Basic shares and convert the company into a privately owned business. I invited him to confirm this in writing. Letters received November and January.

Nov. 1976:

STEETLEY COMPANY, England

On Dec. 16 Jack Laird and Bob Weaver visited Cleveland. Luncheon meeting: HPE, HCR, MM, Jack Laird, Bob Weaver. Laird declared Steetley's intention of a "friendly" acquisition, partial or total. He commissioned Weaver to compile figures on Basic.

Jan. 17, 1977:

HCR advised MM that Weaver's letter with "schemes" was "far out". Weaver's man says IRS may not stand for "Big Bear" Columbus deal. HCR has sent schemes to ETK.

Feb. 10, 1977:

Gerald Duban called. MM advised him no need for "analysis of Basic" pending HCR's satisfaction with Weaver's "scheme". Also we will not furnish any "inside" or "non-public" information. MM confirmed this in letter to Duban Feb. 11, also sent him literature. MM wrote HCR on Feb. 14 re his phone conversation with Duban.

May 3, 1977:

HCR tel. to MM: Weaver's proposal is "not helpful". We decided to let the matter die.

JA 350

[PX 28]

CE INDUSTRIAL
PRODUCTS

INDUSTRIAL PRODUCTS GROUP

Strategic Plan

1978-1984

September 23, 1977

[REDACTED MATERIAL]

F. INITIATIVES

The table of major initiatives which was included in last year's Strategic Plan has been reproduced as follows:

[REDACTED MATERIAL]

Acquire Basic Inc. \$30 million

[REDACTED MATERIAL]

The Industrial Products Group is presently evaluating expansion of its refractories business into the non-alumina based refractories market which accounts for about half of the total refractories market. This market can only be entered by acquisition, and Basic Inc. is the only available acquisition candidate.

[REDACTED MATERIAL]

JA 351

[CE-2-6]

Interoffice Correspondence

CE COMBUSTION
ENGINEERING
Stamford Office

June 6, 1977

TO: Mr. J. B. Kelly

A. J. Santry, Jr.

cc: Mr. J. F. Calvert
Mr. J. R. Rhode

Review of Industrial Products Group Strategic Plan (1976)

The Corporate Staff has reviewed your 1976 Strategic Plans. I want to commend you and your general managers on the general excellence of these plans.

The detailed comments on each Division Strategic Plan should be reviewed carefully by yourself and your Division Management in order that the questions raised can be addressed in your next round of Strategic Plans.

Since each of the Division Strategic Plans has been reviewed in detail, comments on the Group Strategic Plan are limited to the Major Initiatives in the Plan.

It is recognized that the current guidelines for the preparation of Strategic Plans are more specific concerning Major Initiatives than was the case last year and, as a result, your list of Major Initiatives in the September 1977 plans will be significantly changed. However, if you or your staff have any questions concerning the attached comments on your 1976 Major Initiatives, particularly where clarification or more information is requested, such questions can be referred directly to Mr. Calvert.

/s/ A. J. SANTRY, JR.
A. J. Santry, Jr.

[REDACTED MATERIAL]

9. *Acquire Basic, Inc.*

Approval withheld pending clarification.

Two main questions need to be directed at this Initiative -

(a) Why?

(b) How?

[PX 148]

6/27/77

COMBUSTION ENGINEERING

6-12-77 Ray Hegeman talked to AMC, "on behalf of Jim Kelly". CE has allegedly learned from a NY law firm (Sherman-Sterling) that a tender offer may be made for Basic. According to Moody's, Sherman-Sterling are CE general counsel. Hegeman knew that Steetley is after Basic.

6-16-77 MM telephone to Jim Kelly.
Meeting possibility—Friday 6-24-77, 3 PM.
AMC: OK 6-16-77
MJL: OK ~~6-17-77~~
MM: OK 6-16-77

Re Steetley, Kelly said that the Steetley people told him that they tried to acquire Basic. In fact, Steetley proposed to CE that CE join Steetley in acquiring Basic. Kelly thinks that many people know about this. He also confirmed that a lawyer of Sherman-Sterling (counsel of CE) told him that Sherman had been asked to assist a company (whose identity the lawyer would not disclose) in assisting to prepare a tender offer for the shares of Basic.

M. Muller

[PX 151A]

[Handwritten Notes]

From the desk of
M. J. LUDWIG

HCR:

Herewith the C.E. 1976 Annual Report and the analysis we usually make in considering mergers or acquisitions which I promised.

/s/ MJL

7/1/77

TT special

BASIC AND COMBUSTION ENGINEERING

Balance Sheet
December 31, 1976

(000's)	NET ASSETS	BASIC		CE	
		AMOUNT	PERCENT	AMOUNT	PERCENT
Net Current Assets					
Current Assets					
Cash and Equivalent	[2,071]	\$ 2,739		\$ 184,889	
Accounts Receivable	[9,675]	9,244		297,023	
Inventories	[14,515]	13,520		371,755	
Prepaid Items, etc.	[582]	361		21,504	
Total	[26,843]	25,864		875,171	
Current Liabilities	[7,383]	6,375		721,292	
Net Current Assets	[19,460]	19,489	45.9	153,879	27.8
Net Fixed Assets					
Cost	[66,517]	63,592		590,371	
Less Depreciation	[43,823]	41,356		246,990	
Net Fixed Assets	[22,694]	22,236	52.3	343,381	62.1
Other Assets	[733]	780	1.8	56,028	10.1
Net Assets	[42,887]	\$42,505	100.0	\$ 553,288	100.0

JA 354

(Note: material in brackets is handwritten.)

CAPITALIZATION

Long-Term Debt	[9,750]	\$12,075	28.4	\$ 108,753	19.6
Reserves (Income Tax)	—	-0-		44,732	8.1
Minority Interests	—	-0-		1,386	.3
Shareholders' Equity					
Preferred Shares	[3,588]	4,748	11.2	3,674	.7
Common Shares	[29,549]	25,682	60.4	394,473	71.3
Total Shareholders' Equity	[33,137]	30,430	71.6	398,417	72.0
Total Capitalization	[42,887]	\$42,505	100.0	\$ 553,288	100.0
Common Shares Outstanding	[1,337,383]	1,313,150		10,418,726	

JA 355

(Note: material in brackets is handwritten.)

[illegible] 3 for 2 split

BASIC AND COMBUSTION ENGINEERING

JA 356

Income

	1977	1976	1975	1974
BASIC				
Amounts (000's)				
Net Sales.....	[66,744]	\$ 65,948	\$ 53,503	\$ 67,860
Net Income for Common	[3,594]	4,372	2,332	3,532
Net Cash Income for Common ..	[6,669]	6,940	4,518	5,875
Per Share				
Net Income	[2.32]	3.31	11.80	2.73
Net Cash Income		5.25	3.49	4.54
				[2.50]

COMBUSTION ENGINEERING

Amounts (000's)				
Net Sales.....	[2,044,764]	\$1,830,925	\$1,711,151	\$1,428,027
Net Income for Common	[67,180]	[54,205]	43,539	36,371
Net Cash Income for Common ..		85,193	72,248	63,133
Per Share				
Net Income	[4.17]	[3.36]	[2.71]	[2.50]
Net Cash Income		5.04	4.16	3.50
		8.02	7.09	6.19

Note: Basic's income adjusted to eliminate ceramics net loss of \$265(000) in 1974.

(Note: material in brackets is handwritten.)

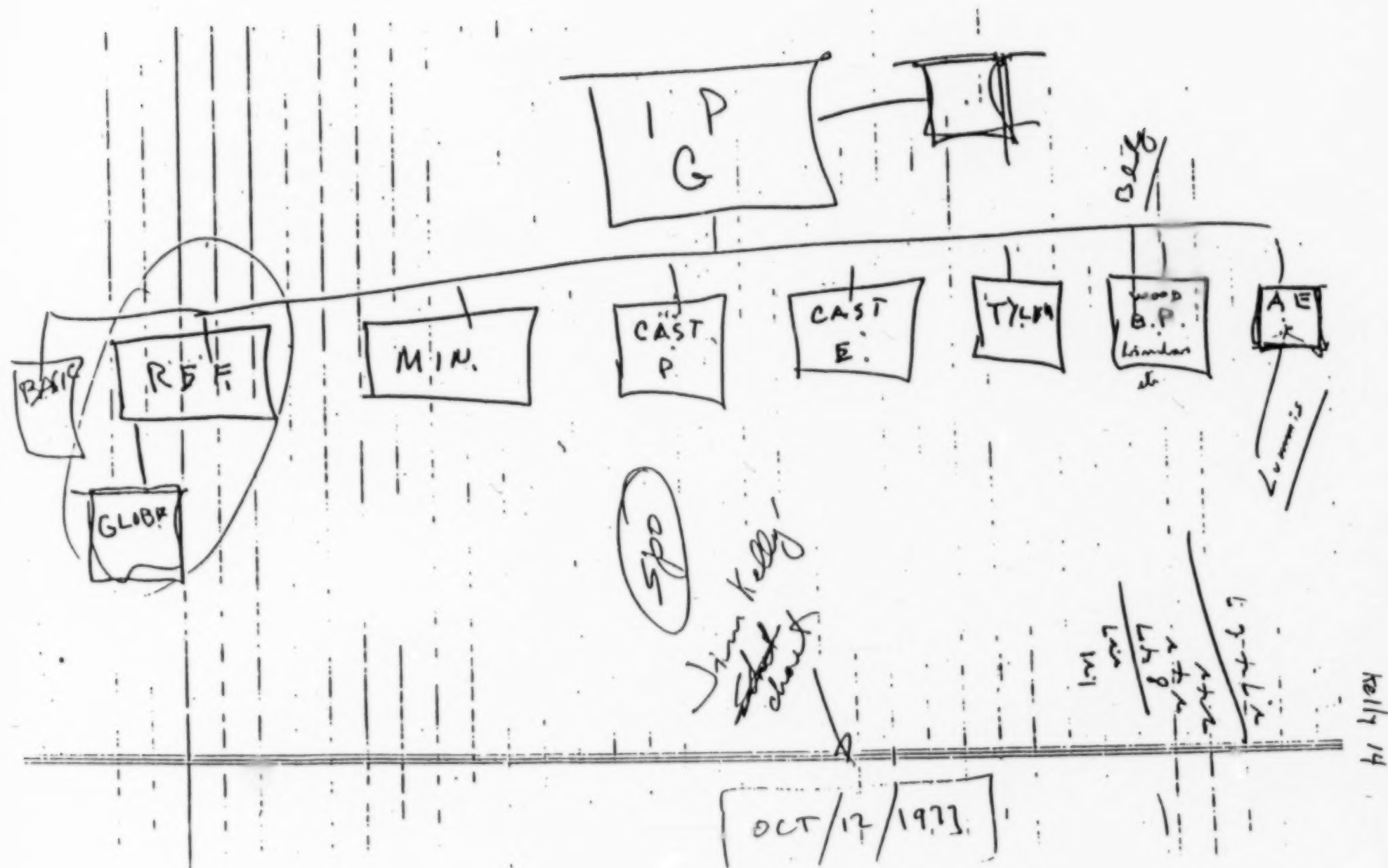
JA 357

BASIC AND COMBUSTION ENGINEERING

Relative Values

	BASIC	CE	BASIC & CE	Market VALUE CE @ \$62.13
Net Income				
1976.....	\$ 3.31	\$ 5.04	.66	\$41.00
1975.....	1.80	4.16	.43	26.72
2-year Average.....	2.56	4.60	.56	\$34.79
1974.....	2.73	3.50	.78	48.46
3-year Average.....	\$ 2.61	\$ 4.23	.62	\$38.52
Net Cash Income				
1976.....	\$ 5.25	\$ 8.02	.65	\$40.38
1975.....	3.49	7.09	.49	30.44
2-year Average.....	4.37	7.56	.58	36.03
1974.....	4.54	6.19	.73	45.35
3-year Average.....	\$ 4.43	\$ 7.10	.62	\$38.52
Dividend - current.....	\$ 1.00	\$ 2.00	.50	\$31.06
Book Value (12/31/76).....	\$19.44	\$36.47	.53	\$32.93
Market Price for 1977				
High	\$19.63	\$63.50	.31	\$19.26
Low	14.38	45.63	.32	19.88
Average.....	\$17.00	\$54.57	.31	\$19.26
Current at 6/30/77	\$16.88	\$62.13	.27	\$16.88

[Illegible Handwritten Notation]



JA 359

[BA-101]

[Handwritten Document]

- Sept. 1977: Ted Mair—(of Wood Legg-Mason) called: "said that V.P. "Duke?" Wadell of Flintcote would like to talk merger.
- Sept. 1977: MM teleph. Wadell—made date for Oct 10-12-77 11:00 AM (informed MJL)
- Frid 7 Oct: MM called Wadell: asked a) if Flinkt were buying shares—
b) if the \$25.00 tender offer rumors were true.
Waddell said *NO* to both.
- Wed 12 Oct: Wadell, Dick West: Bob Rabatsky visited Clevd—MJL, MM & AMC. Talked about Lime project in Kentucke. It seemed clear that Wadell wanted to talk "Merger", but we kept him on Lime.
- Oct 18 77: Wadell called:
a) Flintcote does not think it worthwhile to conduct a study on a Fredonia Lime project, *until* TVA becomes more definitive in their needs for lime. Flinkcote owns a deposit *on* the river in Louisville—they also have an idle rotary kiln. Their 1976 study proved futile—no profit to be made.
b) Rumor that Flintc intends tender offer for "Ideal Basic Inc. Wadell says: no truth to that.

JA 360

c) Flintcote interest in Basic—
will call again

[BA-102]

Oct 21 77:

[Re Plains Dealer article
MM called Waddell:
read him the clip
Wad approved;
asked for cc of clip
sent immediately]

"Basic Inc. stock reaches new high in
heaving trading

Stock of Basic Inc. reached a new high
of 205/8 yesterday on volume of 29,000
shares, closing at 20. It was as low as 15
last month but has been heavily traded
lately, including 40,000 shares Oct. 7.

President Max Muller said the com-
pany knew no reason for the stock's
activity and that no negotiations were
under way with any company for a mer-
ger. He said Flintkote recently denied
Wall-Street rumors that it would make a
tender offer of \$25 a share for control of
the Cleveland based maker of refracto-
ries for the steel industry.

(Note: material in brackets is handwritten.)

JA 361

[BA-103]

October 20, 1977

To: M. J. Ludwig
A. M. Caito

Re: *Flintkote*

On October 13, 1977 Duke Waddell telephoned me as a follow-
up to his visit here (A. M. Waddell, Richard West, Robert
Rabatsky). He told me the following:

- A. They looked into the possibility of a lime project on
our Fredonia deposit. They reexamined an earlier study
by them which dealt with lime production at Flintkote's
Louisville lime property (on the river) and utilizing one
of their idle cement kilns. The project proved economi-
cally marginal and was dropped. Waddell said that
Flintkote would not be interested, not at least until
TVA makes known their need for lime.
- B. Waddell had just received another rumor from Wall
Street which stated that Flintkote is preparing a tender
offer for Ideal Basic Inc. (cement and mineral com-
pany). He said: absolutely no truth to that rumor.
- C. Waddell said Flintkote may be interested in a merger
with Basic, so please keep them in mind in case we need
a friendly ally.

Max Muller

MM:kl

JA 362

[PX 4]

BASIC INCORPORATED
845 Hanna Building
Cleveland, Ohio 44115
(216) 241-5000

Mathew J. Ludwig
Vice President, Finance

- 10/18 JFC/GSP and Fred Rothacker (KP-Cleveland) visited with Mat Ludwig, VP-Fin. Didn't talk ratios due to lack of interest. Company feels some sense of loyalty to First Boston, but opportunity to replace them is real. Discussed tender offer defense and Mat would like to meet with Marty Siegel, perhaps in November. We should also include John Crosby. Mat Ludwig is an avid golfer.
- 10/28 Activity continues in Basic stock. Called Mat. Eager to meet with Marty. Would prefer doing so in Cleveland so that other members of management could join in meeting. If Marty is in Cleveland on Nov 3, Mat would like to hold meeting. Otherwise, he may come to N.Y. on Nov. 9.
- 11/9/77 Ted Thomas, Sec & Tr; Mat Ludwig V.P. Finance, and their lawyer visit K-P and talked with Doug Brown, Joe and Martin Siegel.
1. Talked about tender offer suggested they retain us for 20,000 for six months.

FU December 1 1977

JA 363

[PX 53]

(Newspaper Clipping)

PLAIN DEALER
CLEVELAND, OH
(m) 375,000 (S) 451,000

CLIPPED BY
[BACONS]

OCT 21 1977

[438]

Basic Inc. stock reaches new high in heavy trading

Stock of *Basic Inc.* reached a new high of 20^{5/8} yesterday on volume of 29,000 shares, closing at 20. It was as low as 15 last month but has been heavily traded lately, including 40,000 shares Oct. 7.

President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland-based maker of refractories for the steel industry.

(Note: material in brackets is handwritten.)

[PX 82]

[MJL]

INTER-OFFICE CORRESPONDENCE
Cleveland, Ohio 44115

MEMORANDUM FOR THE FILES

Nov. 11, 1977

On Wednesday, November 9, 1977, M.J. Ludwig and T. Thomas visited three firms in New York

- 1) [REDACTED MATERIAL]
- 2) We next visited with Kidder, Peabody and met with Martin A. Siegel and his associates. Mr. Siegel gave us a rundown of their activities with various companies dealing with mergers and acquisitions, and discussed types of action which should be taken in the event of an unfriendly tender offer. He strongly advised that we engage a financial advisor to assist us in these moves. He also recommended that a financial advisor be engaged on a retainer so that such an advisor could look over the company in a diligent manner so they would be ready to act promptly.

He indicated that Kidder, Peabody's retainer fee would be \$20,000 for the first six months and \$10,000 for subsequent six-month periods. The arrangement will be cancelable at the end of any six-month period. He gave us a check list for defense against tender offers embodying the things we discussed and many others.

- 3) We then visited Morgan Stanley and met with Yerger Johnstone and his associate. He reviewed the matter discussed in Max Muller's memorandum of Nov. 9, 1977. He also advised that in connection with his work for [REDACTED MATERIAL] he had asked a large New York firm to pass on antitrust or other matters in connection with [REDACTED MATERIAL] interest. He received

(Note: material in brackets is handwritten.)

a telephone call from the law firm's Merger & Acquisition's section to the effect that the firm could not take the assignment because of a conflict of interest. He also asked that this information be kept confidential and certainly his firm should not be quoted as the source.

He gave us his card on which he wrote his home, evening and weekend telephone numbers in case we wished to reach him in an emergency. He also stated that because of his connection with [REDACTED MATERIAL], he would not be in a position to be engaged as Basic's financial advisor.

T. Thomas

TT:BR

(Note: material in brackets is handwritten.)

(Illegible
Handwritten
Notation)

JA 366

[CE-2-7]

CE COMBUSTION
ENGINEERING
Stamford Office

January 9, 1978

Mr. J. B. Kelly

A. J. Santry, Jr.

cc: Mr. J. F. Calvert
Mr. J. R. Rhode

Review of Industrial Products Group Initiatives (1977)

The Major Initiatives from your 1977 Strategic Plans have been selected and are commented on herein.

If you or your staff have any questions concerning the attached comments, you may refer them directly to Mr. Calvert.

Comments on the remainder of your plan will be provided by April 15.

/s/ ARTHUR J. SANTRY, JR.
Arthur J. Santry, Jr.

Attachment

Page 2

*REVIEW OF INDUSTRIAL PRODUCTS GROUP INITIATIVES
(1977)*

1. *Acquire Basic, Inc.*

Approval withheld pending developments.

Because of Basic management's attitude, this does not appear to be an active area at present. Insure that corporate management is kept informed.

[REDACTED MATERIAL]

JA 367

[PX 8]

January 30, 1978

MEMORANDUM

TO: Michael H. Lowry
Martin A. Siegel

FROM: Geoffrey S. Parker

cc: Douglas V. Brown
John F. Childs

RE: *Basic Incorporated Fee Letter*

I finally got Mat Ludwig to specify his concern with respect to our fee letter.

As detailed on the attachment, his concerns, as expressed by counsel, relate to liability matters and not to the compensation amount.

He plans to visit Kidder, Peabody during the next few days on an acquisition matter (how much is a certain private company worth) and hopefully we can suggest alternative language at that time.

(Letterhead of Kidder, Peabody & Co., Incorporated
New York, N.Y.)

November 17, 1977

Mr. Max Muller
President
Basic Incorporated
845 Hanna Building
Cleveland, Ohio 44115

Dear Mr. Muller:

We are submitting this letter to confirm our understanding that Kidder, Peabody & Co. Incorporated ("Kidder, Peabody") has been employed to assist Basic Incorporated ("the Company") as financial advisor. The Company agrees to pay us a retainer fee of \$20,000, plus all reasonable out-of-pocket expenses, including fees and disbursements of counsel. Our initial employment will be for the six-month period commencing November 16, 1977, and our fee and out-of-pocket expenses will be payable upon submission of a bill or bills by us at any time after the commencement of this period. Our employment may be extended, by notice from the Company to us, for additional six-month periods upon the terms set forth in this letter except that the retainer fee will be reduced to \$10,000 for each such period.

Any financial advice rendered by Kidder, Peabody pursuant to this letter may not be disclosed publicly in any manner without the prior written approval of Kidder, Peabody.

The Company agrees to indemnify and hold Kidder, Peabody harmless against any losses, claims, damages or liabilities, joint or several, to which Kidder, Peabody may become subject in connection with the services which are the subject of this letter and to reimburse Kidder, Peabody for any legal or other expenses reasonably incurred by it in connection with investigating or defending against any loss, claim, damage or liability or any action in respect thereof; provided, however,

that the Company shall not be liable under the foregoing indemnity agreement in respect of any loss, claim, damage or liability to the extent that a court having jurisdiction shall have determined by a final judgment that such loss, claim, damage or liability resulted from the willful misfeasance or gross negligence of Kidder, Peabody. The indemnity agreement in this paragraph shall, upon the same terms and conditions, extend to and inure to the benefit of each person, if any, who may be deemed to control Kidder, Peabody.

Please confirm that the foregoing is in accordance with your understanding by signing and returning to us the duplicate of this letter attached hereto.

Sincerely,

KIDDER, PEABODY & CO. INCORPORATED

By: _____

Confirmed as of the date hereof:
BASIC INCORPORATED

By: _____
Max Muller

JA 370

BASIC'S OBJECTIONS

1st paragraph, 6th line

Change to: ". . ., including all *reasonable* fees and disbursements of"

2nd paragraph

This is too restrictive. He thinks this prevents Basic from using any Kidder, Peabody advice, outside the confines of their offices. Perhaps we could qualify the sentence by adding language to the effect that this provision shall not prevent Basic from using our advice, and disclosing same, in private meetings when Basic can reasonably expect that the discussions will be kept confidential.

New paragraph

Basic would like to insert a new third paragraph, probably one sentence, in which Kidder, Peabody agrees to maintain the confidentiality of discussions with, and material provided by, Basic Inc.

Page 2, line 4

They have asked us for the deletion of the words "willful" and "gross".

JA 371

[PX 37A]

(Letterhead of Combustion Engineering, Inc.,
Stamford, Connecticut)

[2/13/78 [illegible]—MM]
February 8, 1978

Mr. Max Muller [2/10/78]
President
Basic Incorporated
845 Hanna Building
Cleveland, Ohio 44115

Dear Max:

In accordance with our recent telephone conversation, enclosed is a booklet of our Refractory Division and a pamphlet on Comparative Brands which compete with us.

In addition you are familiar with our Globe Refractories for ladles which include ladle brick, sleeves and nozzles.

I look forward to seeing you at Burke Lakefront Airport on the 27th of February, at 9:00 a.m.

Kindest personal regards.

Sincerely,

/s/ Jim

JBK/k
enclosures

(Illegible Handwritten Notation)

(Note: material in brackets is handwritten.)

JA 372

[PX 10]

(Letterhead of Basic Incorporated, Cleveland, Ohio)

March 14, 1978

Mr. Geoffrey S. Parker
Assistant Vice President
Kidder, Peabody & Co. Inc.
10 Hanover Square
New York, New York 10005

Dear Geoff:

The enclosed duly executed by Mr. Muller is one of the two copies of your letter of February 9, 1978 setting forth our agreement on your assistance to Basic as financial advisor.

Note that Mr. Muller has initialed the Rider and I suggest you do likewise, then send us a photo for our files.

If the memorandum is ready, I will also enclose a copy of Mr. Muller's telephone conversation today with Dr. Chrein. If not, I'll forward it separately. This bears on Mr. Muller's memorandum of March 13th, copy of which I mailed to Mr. Siegel yesterday.

Sincerely,

/s/ M. J. LUDWIG
M. J. Ludwig
Senior Vice President
Finance & Administration

MJL:BR

Enclosure

JA 373

BASIC INCORPORATED

April 11, 1978

Annual Meeting of the Board of Directors

The annual meeting of the Board of Directors of Basic Incorporated was held at the principal office of the Corporation, 845 Hanna Building, Cleveland, Ohio at 11:30 a.m. on Tuesday, April 11, 1978, in accordance with notice duly mailed to each Director, a copy of which is filed herewith.

The following Directors were present: Messrs. M. Muller, H. C. Rose, J. C. Wilson, Jr., S. Eells, Jr., H. C. Lee, M. J. Ludwig and A. M. Caito. Mr. Muller presided and Mr. Ludwig kept the record.

[REDACTED MATERIAL]

—2—

Mr. Muller reported on conversations with Combustion Engineering.

[REDACTED MATERIAL]

—3—

[REDACTED MATERIAL]

—4—

[REDACTED MATERIAL]

There being no further business for consideration, the meeting was adjourned.

Secretary of the Meeting

[Approved]

(Note: material in brackets is handwritten.)

JA 374

BASIC INCORPORATED

Annual Meeting of the Board of Directors

845 Hanna Building
Cleveland, Ohio

April 11, 1978
11:30 a.m.

AGENDA

A. Roll Call (HCR, EQS, JCW, JAG, SE, MM, HCL, MJL, AMC).

[EQS marked *Absent*] and JAG marked *Absent*]

[REDACTED MATERIAL]

F. Reports on company activities:

ii) Other * * * [MM: (REDACTED) C.E.]

(Note: material in brackets is handwritten.)

[PX 27]

(Letterhead of Basic Incorporated, Cleveland, Ohio)

May 12, 1978

Mr. Geoffrey S. Parker
Assistant Vice President
Kidder, Peabody & Co.
10 Hanover Square
New York, N.Y. 10005

Dear Geoff:

Enclosed is our check for \$21,200.61 covering your fee and related out-of-pocket expenses for the period November 16, 1977-May 15, 1978, all in accordance with our agreement dated February 9, 1978 and your invoice of April 26.

JA 375

I am also pleased to serve notice hereby of our election to extend the term of the agreement for an additional six months starting May 16th, 1978 at the reduced fee of \$10,000.

Yours sincerely,

/s/ M. J. LUDWIG

M. J. Ludwig
Senior Vice President
Finance & Administration

MJL:BR

Enclosure

(*Illegible Notation*)

CONFIDENTIAL

BASIC INCORPORATED

Meeting of the Board of Directors

Union Club
Cleveland, Ohio

May 26, 1978
11:00 a.m.

Agenda

A. Roll call (HCR, EQS, JCW, JAG, (*No*), SE, MM, HCL, MJL, AMC).

[REDACTED MATERIAL]

F. Reports on company activities:

ii) Other (*Illegible notation*)

[REDACTED MATERIAL]

—2—

[REDACTED MATERIAL]

Mr. Muller presented an analysis of the Refractories Division of Combustion Engineering and then reviewed the stock market activity of Basic shares.

[REDACTED MATERIAL]

[REDACTED MATERIAL]

There being no further business, the meeting was adjourned.

Secretary of the Meeting

[PX 45]

(Illegible Handwritten Notation)

BASIC, INC.

ASSUMPTIONS AND INFORMATION

1. Data regarding the content of the Corporate expenses are as follows:

1. Corporate executives
2. Corporate accounting, consolidation and financial statement preparation.
3. Corporate headquarters' cost in Cleveland
4. Other income and deduction type items.
5. Exploration of minerals.

From this total above estimates are made of time and direct charges are made to Groups so that the residue is simply the unallocated portion.

2. Definitions of accounting terminology:

Prime cash cost—This is equal to direct material plus direct labor and direct supervision. [Illegible Handwritten Notation]

Production cost—This contains plant manufacturing administration, plant engineering and traffic; plant [product] engineering, safety and cost control, plant accounting; real estate taxes, general maintenance to the plant building; general plant insurance.

(Note: material in brackets is handwritten.)

Technology—This includes lab product development cost both new and existing products.

Administration includes the Corporate allocation plus incentive compensation for the division, and the particular division's President, Secretary, Vice President of Operation.

Other Income and Deductions—This category is made up primarily of gain or loss on disposition of fixed assets, royalty on product sales, discounts and provision for bad debts.

Product Lines

Technical Ceramics—This product line included alumina specialty, electronic products and woolen mills. It was acquired then expanded in Henderson, North Carolina and then finally abandoned by sale to two different parties.

Refractories Division—The following are major product lines:

Raw dolomite—This is marketed to stone for road building, blast and open hearth furnaces and for agricultural feed stock. In the years 1973 and 1974 it should be noted that the agricultural dolomite product is included in the inter-segment sales to the chemical division. Thereafter such sales are recorded as a part of the raw dolomite breakdown.

Dead burned dolomite—This is sold primarily to the open-hearth steel industry and that accounts for the down turn in sales recently. Gross margin declined in 1977 due to the use of higher cost coal which was not fully recovered through increased selling prices.

Both the dead burned and raw dolomite are produced in the Maple Grove, Ohio plant.

Dead burned magnesite—The product is sold in granular form less than 1/4 inch large. It is produced

in the mine at Gabes, Nevada and also from the sea water magnesite at Port St. Joe, Florida which supplies a product used primarily internally within Basic.

This product is sold primarily to electric furnaces, some to open hearth and some to other brick producers.

Special refractories—This includes granular and fluxes and klinker products. Most of these products are used to repair furnaces, both BOF [*Illegible Handwritten Notation*] and open hearth. Product sales are off due to steel and foundry production in 1977.

90% of the items are manufactured in the Maple Grove, Ohio plant.

Tar bonded refractories—This product in brick form is produced at the Maple Grove, Ohio plant and is sold to the steel industry although sales have been declining due to the use of other upgraded products. The use is primarily in the BOF furnaces. In addition, sales have been dropping due to a loss of market share to Harbison-Walker [*and*] into North American Refractories. During 1977 the company experienced a six week strike which caused the gross margin and profits to decline. In addition, there was a need to utilize more raw materials produced from the Florida plant which are at a higher cost and this was not compensated for by increased selling prices.

Plant Capacity

The Maple Grove, Ohio refractory plant is now operating at about 30% of capacity. The plant has several tempering furnaces and is gas fired. The plant operates on one shift and according to Basic personnel is not a high

(Note: material in brackets is handwritten.)

fixed cost operation. In 1973 the plant operated at 60% to 70% of capacity. Hundreds of various shapes and sizes are carried in inventory in the brick plant.

In 1974 the Company adopted the LIFO method of valuing inventories and all of the refractories products are on LIFO.

Intersegment transfers shown in the financial statements represent transfers to the Chemical Division. The policy of transferring is at list price less a discount. The Chemicals Division markets the product and also achieves a profit which is about equal to that recorded on the [*LINE MISSING*]

ELECTRONICS SEGMENT

Products

Background—This segment was started up primarily as a manufacturer of power supply equipment in the 1960's. This is a strong base and forms the basis for the sub-contract product line. Later the company acquired Elgin Electronics which resulted in developing proprietary telephone equipment. In 1975 the company incurred losses as a result of poor conditions in the electronic industry which forced them to lay-off a high number of their engineering staff. This carried over into 1976 and it also generated losses. However, the company turned around in 1977 in both telephone and sub-contract work and is trying to develop independence from the sub-contract work by pushing its proprietary products. Discussion indicated, however, that the Company has serious problems getting any production volume from its telephone equipment plant even though it could sell the equipment without great difficulty.

Printed Circuit Boards and Telephone Dialing and Speaking Equipment are current products. The number of employees at the Company's Waterford, Pennsylvania plant is approximately 350.

[REDACTED MATERIAL]

*Assumptions*1. *Tax Reserves*

- A. Depletion allocated all to Refractories—1978 and 1973 balances based upon tons mined.
- B. Investment tax credit allocated based upon capital expenditures by product line.
- C. Since the minimum tax derives primarily from percentage depletion allowances to which Basic is entitled for tax purposes, this was allocated entirely to Refractories' product line.
- D. Other—was allocated entirely to Refractories.

2. *Outside Debt*

- A. Assumed that \$1,875,000 would be paid quarterly in 1978 (April 1, July 1, and October 1).
- B. Interest would be paid for 9 mos. on the $5 \frac{3}{8}$ insurance note.

3. *Assets Employed*

- A. Working capital/sales ratio used to generate 1978 and 1973 working capital balances assumed .29 in 1978 and .28 in 1973.
- B. Fixed assets for 1978 were computed as follows:

Balance 1/1/78	\$22,693
Assumed Additions	4,000
Depreciation	(3,156)
Assumed Retirements	(200)
	\$23,337

- C. Assets were averaged using beginning and end of year balances.
- D. Assets employed were allocated to each product line given for 1977 and 1976. It was assumed that liabilities were incurred in the same proportion as assets.

4. *Expenses*

- A. Corporate expenses were assumed to be \$750 in 1978 and were allocated to the product lines based upon their percentage of total sales.

5. *Statement Presentation*

- A. Comparative income statements were prepared on a "before interest" basis.
- B. Production O/H and depreciation were shown as being components of cost of goods sold.

CHEMICALS DIVISION

Products

Magnesia chemicals account for the largest segment of the four groups of chemical sales. These chemicals are sold to the paper industry, sugar industry and animal feed which is the largest segment. The product here is known as Magox.

Power chemicals account for the next largest sales segment and are sold to utility companies who add the chemical to the fuel oil as an additive. This division has had problems with the sales force and recently fired their salesmen and have now gone to agents as a method of selling.

The other two product lines are chemicals sold to the rubber industry and Fredonia Valley Quarries.

JA 382

[PX 38]

(Letterhead of COMBUSTION ENGINEERING,
Stamford Office)

Interoffice Correspondence

Memo to File

J. B. Kelly

June 7, 1978

Basic, Inc.

Met this morning in Basic office in Cleveland with Max Muller, Tony Caito and Matt Ludwig to discuss the possible consolidation of our refractories division.

We reviewed the consolidation financial prepared by Preston Insley. After review, Max suggested that Basic buy our Refractories Division for book value. I said that we might consider this for stock of Basic, but not for cash.

I suggested that we consolidate by C-E buying Basic. I said that I thought that \$28/share in cash, or C-E stock would be a price I could recommend to Mr. SANTRY.

They then pointed out that if they were to consider a sale, a price as low as \$28 would be out of the question.

After additional discussion, I posed the question of whether they would be receptive to considering an offer of C-E at some higher price. They agreed to call me the week after next with a response. If the answer is positive, then I will consult with Mr. SANTRY on whether he wishes to make an offer and if so, at what price. The four of us, plus Ed Arnholt and Bob Gates had lunch at Hermit Club.

/s/ J. B. KELLY
James B. Kelly

JBK/k

JA 383

THE FIRST BOSTON CORPORATION
INTER-OFFICE MEMORANDUM

F. Perella Exh. 6 for ID

R. Bergin

5-7-82

M & A Contact Memo

DATE: July 11, 1978FROM: Perella

☒ Telephone
☐ Meeting

TO:	Perella	Tomlinson (Management)
	Hill	Swenson "
	Wasserstein	Wadsworth "
	Lambert	Connor "
	Stolberg	
	Elliott	OTHERS: _____
	Lirola	_____
	Maher	_____
	Morrill	_____
	Young	_____
	Cortright	_____
	McVeigh	_____
	Styblo	_____
	Needham (New Business)	_____
	Chanock (" ")	
	M&A Contact Files	
	8th Floor Company Files	

RE: Combustion EngineeringCONTACT: Lambert Gross VP Fin

PHONE: _____

REPORT: _____

(1) We did study for them on BASIC INC.about 1 year ago (BD Young)(Cleveland, Ohio)(2) BASIC hired Kidder Peabodybecause 3 largest s/h wantto [crossed out seel] sell tax free

(3) Gross not hot for this — Kelly

is

(4) Please get old study update it

ACTION: for meeting with Santry & boys next week

July 18, 19, 20 or 21 they will sell us to

[PX 18]

(Letterhead of THE FIRST BOSTON CORPORATION;
New York, N.Y.)

July 19, 1978

Mr. F. Gregg Bemis, Jr.
Vice President
Combustion Engineering, Inc.
900 Long Ridge Road
Stamford, Connecticut 06902

Dear Gregg:

Enclosed is a copy of the Return on Investment Analysis which I telecopied to Mr. Kelly on Monday. Case I utilizes the earnings projections which Mr. Kelly provided in the presentation; assuming a \$32 price per share, this case yields an ROI ranging from 20% to 22%. Case II utilizes more conservative earnings projections than Case I; assuming a \$32 price per share, this case yields an ROI ranging from 16% to 18%.

The Quotron shows a high of \$28 1/2 today (volume of 20,000 shares) and the stock is trading at \$27 5/8 currently. It closed yesterday at \$26 1/2. As you recall, the merger consequences were calculated exactly one week ago using \$22 1/8 as the current price for the target.

If we can provide any further information, please do not hesitate to call on us. Also enclosed is a set of the merger

consequences (Schedule II in the book) which have been corrected for typographical errors.

Sincerely,

/s/ TANYA STYBLO
Tanya E. Styblo

enclosures

Page 2

RETURN ON INVESTMENT ANALYSIS

Basic Assumptions:

Earnings -	Net income is projected to grow 16% (10%) compounded in Case I (Case II) during 1978-1982 and 12% (10%) compounded during 1983-1987.
Capital Funds -	Investment in plant increases slightly less than depreciation during 1978-1983 and increases modestly more than depreciation during 1984-1987. Working capital needs increases with sales.
Marketable Securities -	Cash and equivalents of approximately \$2,000,000 remain in BAI to satisfy working capital needs.
Leverage -	The debt-to-equity ratio is maintained at its current level.
Conclusion -	In Case I a \$32 price per share provides an ROI ranging from 20% to 22%. In Case II a \$32 price per share provides an ROI ranging from 16% to 18%.

JA 386

Page 3

RETURN ON INVESTMENT ANALYSIS

Assumptions

	CASE I	CASE II
Years analyzed	10	10
Earnings growth		
1978-82	16%	10%
1983-87	12%	10%
Terminal multiple	7x	7x

Results

	HURDLE RATE					
	12%	14%	16%	18%	20%	22%
Case I						
Purchase Price	\$89,720	\$78,350	\$68,770	\$60,670	\$53,790	\$47,920
per share	\$ 56	\$ 49	\$ 43	\$ 38	\$ 34	\$ 30
Case II						
Purchase Price	\$69,270	\$60,740	\$53,540	\$47,450	\$42,270	\$37,840
per share	\$ 43	\$ 38	\$ 34	\$ 30	\$ 27	\$ 24

JA 387

[PX 17]

(Letterhead of COMBUSTION ENGINEERING,
- Stamford Office)

Interoffice Correspondence

CONFIDENTIAL

Mr. J. F. Calvert

J. B. Kelly

July 20, 1978

IPG Acquisitions

Since we have been missing each other on this subject, the following is background on the three acquisitions we are considering:

[REDACTED MATERIAL]

BASIC, INC.

Attached copy of my memo to Mr. Santry gives current status. Also attached are copies of my slide presentation on Basic which was presented last week when First Boston came to Stamford to discuss Basic. I have attached a copy of First Boston "Return on Investment Analysis". First Boston personnel stated that at a price of \$32 the ROI's developed were among the best that they had seen in all the companies reviewed.

This would be an excellent opportunity for C-E if we could acquire for \$32/share.

/s/ JAMES B. KELLY
James B. Kelly

/k
attachments

JA 388

Page 2

(Letterhead of COMBUSTION ENGINEERING,
Stamford Office)

Interoffice Correspondence

Mr. A. J. Santry, Jr.

J. B. Kelly

July 19, 1978

Basic, Inc.

I talked to Max Muller, President of Basic, today and learned the following:

- 1) His stock exchange specialist sees no concentrated buying.
- 2) Stock hit a high of 28-1/2 today and then dropped off to 27-6/8.
- 3) Muller's answer to any outside inquiry continues to be that Basic management knows nothing that could be causing the rise.
- 4) His antitrust lawyer is on vacation until August 3rd.

[REDACTED MATERIAL]

What this means, is that we will not make any proposals to Basic until mid-August at the earliest. I believe such a program works in our favor in that it gives the stock a chance to fall back to more reasonable levels.

- 5) Muller agrees that this slow, deliberate approach is the way to go.

Page 3

[REDACTED MATERIAL]

I will be in [Redacted Material] next week, but could be back East on Thursday if you wish to discuss either Basic or [Redacted Material] with the Executive Committee or Board.

/s/ JAMES B. KELLY

James B. Kelly

/k

JA 389

Page 4

BUSINESSES

MINERALS PRODUCED

DOLOMITE
LIMESTONE
MAGNESITE
MAGNESITE (SEA WATER)

MINERAL BASED PRODUCTS

BOF BRICK
SPECIALTIES
DOLOMITE & MAGNESITE GRAIN
CHEMICALS

ELECTRONICS

Page 5

ASSUME ALL PREFERRED CONVERTS AND ALL
OPTIONS EXERCISED BY YEAR END 1978

SHARES OUTSTANDING	1,563,763
NET WORTH	\$37,000,000
DEBT	\$ 8,000,000
BOOK VALUE	\$ 23.66

Page 6

BASIC MANAGEMENT GOALS

- 1) JOIN C-E
- 2) GET FAIR PRICE
- 3) AVOID EXPOSURE
- 4) TAX FREE EXCHANGE

C-E MANAGEMENT GOALS

- 1) NO GOODWILL
- 2) PAY LOWEST PRICE
- 3) POOLING, IF POSSIBLE

Page 7

ALTERNATIVES

- 1) *STOCK FOR STOCK*
 ADVANTAGES — TAX FREE
 — POOLING
 — NO GOODWILL
 DISADVANTAGES — EXPOSURE
- 2) *CASH TENDER OFFER FOR ALL STOCK*
 ADVANTAGES — NO GOODWILL
 — LESS EXPOSURE
 DISADVANTAGES — NO TAX FREE
 — NO POOLING
- 3) *TENDER OFFER FOR LESS THAN 50%
 THEN C-E STOCK FOR BALANCE*
 ADVANTAGES — NO GOODWILL
 — LESS EXPOSURE
 — TAX FREE FOR 50%
 DISADVANTAGE — NO POOLING

Page 8

EXAMPLE OF ALTERNATIVE (3)

BASE PRICE FOR BASIC, INC. - \$30/SHARE
 BUY 781,881 FOR \$30 EACH = \$23,456,445
 BUY 75,000 WARRANTS FOR \$18 EACH = 1,350,000
 CASH \$24,806,445

BASIC 1978 AFTERTAX INCOME	5,700,000
AFTER COSTS OF \$24,806,445 AT 5%	= 1,240,000
AFTERTAX INCOME AFTER INTEREST	4,460,000

EXCHANGE C-E STOCK FOR 781,881 SHARES OF BASIC AT .75 C-E PER SHARE	= 586,410 SHARES
---	------------------

\$4,460,000 586,410 SHARES	= EARNINGS/SHARE OF \$7.60
-------------------------------	----------------------------

Page 9

HOW DO WE GET RID OF GOODWILL? [of 13,000,000]

LIFO RESERVE	\$ 5,000,000
--------------	--------------

PLANT & MINERAL LAND
ON BOOKS FOR \$23,000,000.

CURRENT VALUE AT LEAST \$100,000,000	67,000,000
---	------------

AVAILABLE TO ABSORB GOODWILL	\$72,000,000
------------------------------	--------------

[Handwritten Notes]

MAX MULLER
845 Hanna Building
Cleveland Ohio 44115

7-21-78

Sent to

Jim Kelly

(Note: material in brackets is handwritten.)

JA 392

Product	S.I.C. CODE	TONS	SALES
Barblok DM-50, M & P			
Bartemp DM-50, M & P	3297016	21714	8320460
Basibrik PV, Basiblok PV	3297017	3520	1859563
Basibrik P, Baublok P	3297018	429	207964
Tarmix M & DM-50	3297061	561	138959
Ramset & PB			
Ramiclass & 95			
Basipatch & Basichase 98			
Shovelpatch	3297065	16888	4444598
Gunmag & PB			
Gundol (all)			
Gunmix			
Gunblend E			
Gunchrome M			
Gunclase	[illegible]	[illegible]	13088731
Basimix	3297094	10	1421
Dead-Burma Magnesite			
Direct as finished product	3295023	16489	[illegible]

(Note: entire spread sheet is handwritten.)

JA 393

TABLE II
COMPARABLE PRODUCTS

1977

SIC Code	Description	\$ x 000		
		Industry	Basic	C-E
3297061	Basic bonding mortars (Magnesite or Chrome Ore)	\$ 2,553	\$ 139	\$-0-
3297065	Plastics—Basic, Magnesite, Dolomite or Chrome Ore	25,638	4,444	145
3297071	Basic non-clay gunning mixes	75,000	13,088	99
	Total	<u>\$103,191</u>	<u>\$17,671</u>	<u>\$244</u>
	% of Industry		17.12	0.24

TABLE III
COMBUSTION ENGINEERING
TOTAL REFRACTORY SALES

1977

SIC Code	Description	\$ x 000
	C-E Refractories—(Ex Basic)	\$89,778
	C-E Refractories—Basic	244
	Subtotal	<u>\$90,022</u>
3255094	C-E Minerals—other clay materials in lump or ground form	12,000*
3297094	C-E Minerals—other non-clay materials in lump or ground form	27,000*
	Subtotal	<u>\$39,000</u>
	Combustion Engineering Industry	\$129,022 \$1,171,992
	% Combustion Engineering	11.02

* Estimated

JA 394

[PX 216]

[Handwritten Notes]
MAX MULLER
845 Hanna Building
Cleveland Ohio 44115

Sent cc to Jim K

7/25/78

[PX 22]

COMBUSTION ENGINEERING, INC.

Meeting of the Executive Committee

July 27, 1978

A meeting of the Executive Committee of Combustion Engineering, Inc. was held at the offices of the Company, 900 Long Ridge Road, Stamford, Connecticut on Thursday, July 27, 1978 at 12:40 p.m.

PRESENT:

Messrs. W. Van Alan Clark, Jr.
Robert M. Jenney
George Putnam
Arthur J. Santry, Jr., Vice Chairman
Robert G. Stone, Jr., Chairman

being all of the members of the Committee.

Present by invitation was James B. Kelly, Vice President-Industrial Products Group.

Mr. Robert G. Stone, Jr., Chairman of the Committee presided, and Mr. Richard H. Troy, an Assistant Secretary of the Company recorded.

[REDACTED MATERIAL]

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Page 2

Mr. Kelly then referred to the subject of Basic Refractories, Inc. ("Bas with respect to which there had been a detailed presentation and discussion at th meeting of the Executive Committee on November 18, 1976. Mr. Kelly gave an updat with respect to the current situation concerning Basic. It was the sense of the meeting that the management of the Company should continue to proceed with its investigations, preparations and, as appropriate, negotiations with respect to the possible acquisitions of Basic.

There being no further business, the meeting, upon motion, adjourned.

/s/ RICHARD H. TROY
Secretary

[PX 42]

[Handwritten Notes]

MAX MULLER
845 Hanna Building
Cleveland Ohio 44115

7-21-78

Jim:

Enclosed are,
what we believe,
accurate # sales 1977
s/s Sic numbus.
Raw Dolomite &
some chemicals
do not identify
in 7 digits.

Call if you need
addl info.

Best
Max

JA 396

1977 Sales

Product	S.I.C. CODE	TONS	5A
Tarblok DM-50, M&P			
Tartemp DM-50, M&P	3297016	21714	8320
Basibrik PV, Baublok PV	3297017	3520	1859
Basibrik, P, Baublok P	3297018	429	207
Tarmex M & DM-50	3297061	561	138
Ramert & PB			
Ramichase & 95			
Basipatch & Basichase 98			
Shovelpatch	3297065	16888	4444
Gunmag & PB			
Guncloth (all)			
Gunmix			
Gunblend E			
Gunchrome M			
Gunchase	3297071	74084	13088
Basimix	3297094	10	1
Dirch as finished product	3295023	489	2395
To customers for reprocessing	3295025	12974	1335
Raw Dolomite			
Flux, refractory, sinter, commercial & agatone	1422	560878	1115
Dead-Burned Dolomite			
Magnifer & Syndolag	3274	151379	6295
Raw Magnesite			
Magnesite & Brucite	3295	1395	82
Light-burned Magnesite			
Magox, Oxymag & Brucimag	2819	39861	5971

(Note: entire spreadsheet is handwritten)

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1977 Sales

Product	S.I.C. CODE	TONS	5A
Seawater Magnesia			
DB 98, DB95, Magox SW,			
Aquamag			
Gramimag and Slurry	2819	—	3699
Power Chemicals			
All Liquimag	2519	1228983 gal.	2156
Rubber Chemicals			
Decals, Magtoxop, Liquispere	2819	5565460 lb.	1710
Fredonia Valley			
All stone products	1422		1694
Miscellaneous Sales			2
Total			\$55,298

(Note: entire spreadsheet is handwritten)

[PX 43]

[Handwritten Notes]

MAX MULLER
845 Hanna Building
Cleveland Ohio 44115

7/22/78

Jim:

We feel that all
our products are
now "SICed" properly

Max

TABLE I

U.S. DEPARTMENT OF COMMERCE
REFRACTORIES—MQ32C(77)-3

1977

SIC Code	Description	\$ × 000
3255011)		
3255045)	Fireclay, brick and shares	\$ 77,188
3255015	Superduty fireclay brick and shapes	38,863
3255021	High alumina brick and shapes	90,168
3255031)		
3255035)	Ladle brick	46,793
3255041	Sleeves, nozzles, runner brick	21,704
3255026)	Insulating firebrick 1600° to 2300°F	4,511
3255027)		
3255023	Insulating firebrick to 2800°F	22,232
3255024	Insulating firebrick to 2800°F and over	5,917
3255047	Hot top refractories	1,752
3255053	Refractory bonding mortars, wet and dry	20,255
3255061	Plastic refractories and ramming mixes	24,457
3255063	High alumina plastic refractories and ramming mixes over 50% to 87.5%	27,235
3255065	Castable refractories clay	32,034
3255067	High alumina castable refractories	16,946
3255069	Insulating - castable	14,896
3255071	Fireclay gunning mixes	12,787
3255075	High alumina gunning mixes	
3297012	Silica brick and shapes	28,254
3297052	Mullite brick and shapes	12,815
3297053	Extra high alumina brick and shapes	26,543
3297055	Zircon and zirconia brick	11,522
3297058	Molten cast, fosterite	unknown
3297062	High alumina mortars over 60%	6,486
3297065	Plastic refractories and ramming mixes— Basic, Magnesite, Dolomite or Chrome	25,638
3297067	Other non-clay plastic refractories	31,164

SIC Code	Description	\$ × 000
3297071	Basic non-clay gunning mixes including chrome, chrome magnesia, dolomite	75,000*
3297073	Other non-clay gunning mixes including extra high alumina, mullite, etc.	6,000*
	Total	\$681,130
	Less SIC 3297065	25,638
		655,492
	Less SIC 3297071	75,000
	Industry total for C-E Refractories type products	\$580,492
	C-E Refractories—Year 1977	\$ 89,778
	C-E Refractories—% of Industry	15.46

(corrected) [as of July 21]

TABLE II
COMPARABLE PRODUCTS
1977

SIC Code	Description	\$ × 000		
		Industry	Basic	C-E
3297061	Basic bonding mortars (Magnesite or Chrome Ore)	\$ 2,553	\$ 139	\$-0-
3297065	Plastics—Basic, Magnesite, Dolomite or Chrome Ore	25,638	4,444	145
3297071	Basic non-clay gunning mixes	75,000	13,088	99
	Total	\$103,191	\$17,671	\$244
	% of Industry		17.12	0.24

(Note: material in brackets is handwritten)

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TABLE III
COMBUSTION ENGINEERING
TOTAL REFRACTORY SALES

1977

<u>SIC Code</u>	<u>Description</u>	<u>\$ x 000</u>
	C-E Refractories—(Ex Basic)	\$89,778
	C-E Refractories—Basic	244
	Subtotal	\$90,022
3255094	C-E Minerals—other clay materials in lump or ground form	12,000
3297094	C-E Minerals—other non-clay materials in lump or ground form	27,000
	Subtotal	\$39,000
	Combustion Engineering	\$129,022
	Industry	\$1,171,992
	% Combustion Engineering	11.02

[PX 64]

NEWS RELEASE

Prepared By:
Young-Liggett & Company
1211 Superior Building,
Cleveland, Ohio 44114

Agency Contact: Davis Young
216-621-1080
Client Contact: M. J. Ludwig
216-241-5000

Prepared for: Basic Incorporated
845 Hanna Building
Cleveland, Ohio 44115
(NYSE-BAI)

Release Date: IMMEDIATELY
9/25/78

CLEVELAND, OHIO—Basic Incorporated (NYSE-BAI) today reported that, although confident of the company's current and future business

JA 401

prospects, management is unaware of any present or pending company development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days.

In the first half of its current fiscal year, ending June 30, the company reported earnings per share of \$1.81 compared with earnings per share of \$1.45 in the first half of 1977 and \$1.37 in the last half of 1977. Sales in the first half of 1978 were \$40,007,000 compared with \$35,300,000 in the first half of 1977 and \$31,447,000 in the last half of 1977.

Basic Incorporated produces refractory materials and chemical and electronic products.

[PX 125]

Interoffice Correspondence

Mr. J. B. Kelly

Lambert J. Gross

cc: Mr. A. J. Santry, Jr.

September 14, 1978

The attached draft of proposal letter was telecopied to us today by Joe Perella of First Boston.

/s/ LAMBERT J. GROSS

Lambert J. Gross

LJR/rs

Attachment

DRAFT—Proposal Letter

September 14, 1978

It was good to talk to you last week and after discussing the matter further within our Company, we are pleased to put forth the following proposal.

Combustion Engineering, ("C-E"), hereby proposes to acquire Blank, Inc. for \$32 per share subject to the approval of

an agreement in principle by the Boards of Directors of the two companies.

We would plan to implement the transaction in the following manner:

a) After announcement of the agreement in principle, C-E would request a No-Action Letter by the Securities and Exchange Commission allowing it to purchase up to 15% of Blank's outstanding common stock on the New York Stock Exchange.

b) Subsequently, a merger would be effected whereby an additional 30% of Blank, Inc. could be exchanged for \$32 in cash and the remaining shares, at least 55% of total shares outstanding, would be exchanged for C-E common stock at an exchange ratio of _____, not to exceed _____ and not to fall below _____, to create a value of \$32 in C-E stock with a dividend of approximately \$_____. The stock portion of a merger would be designed to achieve tax-free treatment to Blank stockholders.

If you have any questions on the proposal or would like to discuss any aspect of a possible combination of our two companies, we shall be pleased to meet with you at a mutually convenient time and place. We would appreciate a response no later than *September _____, 1978.*

[DX I]

—BASIC INC CAN'T EXPLAIN STOCK ACTIVITY

CLEVE -DJ- BASICS INC SAID IT ISN'T AWARE OF ANY PRESENT OR PENDING COMPANY DEVELOPMENT TO EXPLAIN THE UNUSUAL TRADING ACTIVITY OF BOTH ITS COMMON AND PREFERRED STOCK ON THE NEW YORK STOCK EXCHANGE.

THE COMMON IS TRADING AT 34 1-4 UP 1-2 ON 2,600 SHARES. THE PREFERRED HAS NOT YET OPENED.

YESTERDAY BASIC COMMON CLOSED AT 33 3-4 UP 3 3-8 AND PREFERRED CLOSED AT 72 3-4 UP 5 3-4. ON FRIDAY THE COMMON CLOSED UP 2 1-6 AND THE PREFERRED WAS UP 6.

BASIC HAD FIRST HALF EARNINGS OF \$2.7 MILLION OR \$1.81 A SHARE UP FROM \$2.1 MILLION OR \$1.45 A SHARE A YEAR EARLIER. SALES ROSE TO \$40 MILLION FROM \$35.3 MILLION.

-0- 10 27 AM. EDT SEPT 26-78.

[PX 65]

BASIC INCORPORATED

Nine Months Report 1978

Earnings per share of \$1.32 in the third quarter and \$3.13 in the first nine months exceeded those in the like periods of last year by 16% and 20%, respectively, establishing new quarterly and nine months records.

With regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months.

Max Muller

November 6, 1978

President and Chief Executive Officer

Refractories

Tar-bonded and burned magnesite brick; magnesite, dolomite-magnesite and chrome gunning and ramming specialities; dead-burned magnesite and dolomite grain; dolomitic lime and limestone; used principally in steelmaking.

Chemicals

Magnesium oxide for chemical processing and animal feeds; specialty chemicals for rubber and plastics; fuel additives for

electric power generation; high-calcium limestone for agricultural soil conditioning and underground coal mining.

Electronics

Power and interface equipment for telephone systems; custom-designed power sources; magnetic components; printed circuits; electronic assemblies.

CONDENSED BALANCE SHEET

	As of September 30	
	1978	1977
<i>Assets</i>		
Current assets		
Cash and certificates of deposit	\$ 1,985,213	\$ 2,422,224
Receivables	14,588,026	12,895,731
Inventories		
Finished goods	2,097,050	2,127,200
Raw and in-process materials	5,060,226	5,481,162
Repair parts and supplies	5,712,855	5,168,878
	12,870,131	12,777,240
Prepaid insurance	541,806	559,319
	29,985,176	28,654,514
	As of September 30	
	1978	1977
Investments and other assets	755,159	684,344
Property, plant and equipment	69,394,272	65,404,229
Less allowance for depreciation	46,077,726	43,188,496
	23,316,546	22,215,733
	<u>\$54,056,881</u>	<u>\$51,554,591</u>

Liabilities and Shareholders' Equity

Current liabilities		
Accounts payable	\$ 6,212,536	\$ 4,833,723
Other current liabilities	1,915,378	1,750,091
Income taxes	1,401,680	527,004
	9,529,594	7,110,818
Long-term debt	9,187,500	11,262,500
Shareholders' equity		
Cumulative Serial Preference Shares—		
\$50 par value		
Authorized 140,000; outstanding		
5% Convertible Preference		
Shares—56,362 at September		
30, 1978 and 88,858 at September		
30, 1977	2,818,100	4,442,900
Common Shares—\$1 par value—		
Authorized 3,000,000 at		
September 30, 1978 and 1,900,000		
at September 30, 1977;		
outstanding 1,430,443 at September		
30, 1978 and 1,347,350		
at September 30, 1977	1,430,443	1,347,350
Capital surplus	10,910,305	9,585,723
Retained earnings	20,180,939	17,805,300
	35,339,787	33,181,273
	<u>\$54,056,881</u>	<u>\$51,554,591</u>

Interim amounts are not necessarily indicative of the full year and are subject to year-end audit.

JA 406

[PX 67]

BASIC INCORPORATED

Meeting of the Audit Committee

November 1, 1978

A meeting of the Audit Committee of the Board of Directors of Basic Incorporated was convened at 10:00 A.M. through a conference call arrangement whereby Audit Committee members H. C. Rose and J. C. Wilson participated over the telephone from California and Florida respectively, and E. Q. Sylvester in the offices of the Company. Also present at the meeting in the Company's offices were M. J. Ludwig and E. P. Arnolt of Basic Incorporated and Ron Knaggs of Ernst & Ernst.

The Committee reviewed photocopies of the items proposed to comprise the interim report for the first nine months of 1978. Mr. Rose suggested a few minor changes with respect to the text of the Management's Discussion and Analysis of the Results of Operations and the President's comments. The other Committee members agreed with these suggestions and the Committee indicated that the interim report as so modified could be printed and released.

The next meeting of the Audit Committee has been scheduled for 10:30 A.M., November 8, 1978 at the offices of the Company to consider other pending matters within the Committee's purview.

The meeting was adjourned at approximately 10:15 A.M.

/s/ H. C. ROSE

H. C. Rose
Acting Chairman
of the Audit Committee

JA 407

[PX 136]

[Handwritten Notes]

MAX ph Fla 11/1/78

sat

\$4020/sh 1978

oper alone 4.60

legit down

1.20 1.40

Jim Weeks Comb
to Cleve Mon Nov 27

CE 45 ► 50¢ DIV

[PX 34]

(Letterhead of BASIC INCORPORATED, Cleveland, Ohio)

November 13, 1978

Mr. Geoffrey S. Parker
Assistant Vice President
Kidder, Peabody & Co., Inc.
10 Hanover Square
New York, New York 10005

Dear Mr. Parker:

Enclosed is our check in the amount of your invoice dated November 6th.

I am also pleased to advise you that we hereby elect to extend our agreement for an additional six months starting today on

the same terms and conditions applicable to the period ended November 15, 1978.

Sincerely,

/s/ M. J. LUDWIG
M. J. Ludwig
Senior Vice President
Finance & Administration

MJL:rc

Enclosure

[PX 40]

11/27/78

[Handwritten Notes]

Basic meeting

I met this morning with Max Muller, Tony Caito, and Mat Ludwig at Basic's office in Cleveland. I told them that we had not been back to them since this summer because of the relative low P/E of CE stock made a stock for stock transaction unattractive to CE. An appropriate multiple for Basic over market price would result in dilution for CE. I suggested that the concept of part cash (49% or less) and balance securities be considered.

This would help the dilution period and in view of the improved situation on capital gains might be acceptable to a significant number of shareholders.

In response to a price I suggested \$35. They didn't reject such a value but felt the price too low compared with market history over the last six months. They did not believe the market price high in relationship to their current earnings outlook of close to \$5 per share. They stated that they are not operating at a high market level because of merger rumors.

They thought the better market performance resulted from their good earnings performance and prospects and the recognition of the fact that their mineral reserves are substantially undervalued. They stated they had never heard any rumors about acquisition by CE.

We left the meeting with an action program on their part which would be a review of whether cash or cash plus securities would be acceptable to them. If so they would speak to Kidder Peabody for advice. A next step after that might be a meeting between Kidder Peabody and First Boston to see if the banks could agree on values.

JB Kelly

Page 3

[Handwritten Notes]

Get back to Max on 1978, 9, 80 sales & profits.

1978		1979		1980
7,500,000		7,500,000		7,500,000
[illegible]	P/E	[illegible]		
25%	7.3	35		54,731,705
29%	7.5	36		56,295,468
32%	7.7	37		57,859,231
36%	7.9	38		59,422,994
39%	8.1	39		60,986,757
43%	8.4	40		62,550,526

grad price of 60,000,000 or 8.4 x earnings

9 x assets [illegible]

[Buy in \$60,000,000 of shares at say \$36—1,666,000 (crossed out material)]

Give \$60,000,000 of preferred stock paying divided of say 8% give \$40/share for 750,000 share = 30,000,000 interest out of 1,500, AT at 10%

Give \$30,000,000 of \$40 for (75[illegible] preferred stock with 8% rate \$3.20 [illegible (crossed out material)])

750,000 shares
at \$3.20

2,400,000

1,500

750,000

15,750,000

81,000,000

4,000,000

15

\$5.14 vs. \$5.23

3,500,000

add 23¢/share

Shares 1,563,763

x 35

CB =

\$54,731,705

Tender offer for all or 49%. If 49% subsequent exchange of preferred for balance—no [illegible] fund.

[REDACTED MATERIAL]

REF.

4,100,000

5,400,000

1978

7,282,000

138

1979

6,200,000

136

1980

7,200,000

140

[REDACTED MATERIAL]

COMBUSTION ENGINEERING, INC.

Meeting of the Executive Committee

December 14, 1978

A meeting of the Executive Committee of Combustion Engineering, Inc., was held at the offices of the Company, 277 Park Avenue, New York, New York on Thursday, December 14, 1978 immediately following the meeting of the Board of Directors.

PRESENT:

Messrs. Robert G. Stone, Jr., Chairman
W. Van Alan Clark, Jr.
Robert M. Jenney
George Putnam
Arthur J. Santry, Jr., Vice Chairman

being all the members of the Committee.

Present by invitation were Messrs. James B. Kelly, Vice President-Industrial Products Group, Richard J. Hallinan, Vice President and Secretary of the Company, Richard H. Troy, an Assistant Secretary of the Company and Messrs. Joseph R. Perella and Bruce Wasserstein of The First Boston Corporation.

Mr. Robert G. Stone, Jr., Chairman of the Committee, presided, and Mr. Richard J. Hallinan, Secretary of the Company, recorded.

At the request of the Chairman, Mr. Kelly commenced a discussion with respect to the possible acquisition of Basic Incorporated ("Basic"). He stated that recent conversations with the management of Basic indicated that Basic might well be receptive to receiving an acquisition offer from the Company. He further stated that he was not recommending that the Committee consider any offer which would not be acceptable to Basic. He referred to the detailed presentation and discussion which had taken place at the meeting of the Executive Committee on

November 18, 1976 and to a further presentation and discussion at the meeting of the Executive Committee on July 27, 1978. Mr. Kelly then gave an updated presentation with respect to the business of Basic and its sales, earnings, assets and net worth. Mr. Perella and Mr. Wasserstein gave their views with respect to the price at which it would be appropriate for the Company to consider the acquisition of Basic.

After a full discussion, upon motion, duly seconded, it was unanimously

RESOLVED, that the proper officers of the Company be, and they hereby are, authorized to negotiate for and acquire, whether by way of private purchase, tender offer, merger or other transaction, any and all of the capital stock of Basic Incorporated ("Basic") in such form of transaction or transactions and upon such terms and conditions as they shall deem reasonable, and in connection therewith, to make such filings with federal, state and local governmental authorities as may be reasonable and necessary, to retain the services of a dealer manager, depository, forwarding agent, information agent and other persons and entities for the rendering of advice and services in connection with the transactions contemplated, and to execute and deliver all documents, and make all payments and take all further actions which may be necessary or reasonable in the consummation of such transactions.

FURTHER RESOLVED, that the President, any Vice President, any Assistant Secretary, the Assistant Treasurer and any Assistant Controller be, and each hereby is, authorized to execute and deliver any purchase agreement, merger agreement, note, guarantee, filing, or other agreement or document in furtherance of or in connection with the proposed acquisition, including any documents or agreements amending, extending, waiving the provisions of, terminating, or otherwise affecting any of the forego-

ing acts, agreements, documents or filings; provided, however, that the price to be paid for the capital stock of Basic shall not exceed \$46 per common share; and provided, further, that the acquisition hereby authorized, be acceptable to the management and directors of Basic.

There being no further business, the meeting, upon motion, adjourned.

Secretary

[PX 251]

NEWS FROM BASIC INCORPORATED

FOR RELEASE IMMEDIATELY
(12/18/78)

CONTACT: C.W. Collins Phone: 216-241-5000
845 Hanna Building, Cleveland, Ohio 44115

BASIC INCORPORATED APPROACHED FOR MERGER

Cleveland—Basic Incorporated, Cleveland, Ohio, said today that it has been approached by a company indicating an interest in acquiring Basic. A spokesman for Basic pointed out that no offer has yet been made and that the other company has stated that it would only proceed on a basis acceptable to it and to the management of Basic. Basic stressed that while a meeting has been scheduled for Tuesday with representatives of the other company, it would be premature for Basic to speculate on the possibility of any transaction taking place. The New York Stock Exchange has temporarily halted trading in Basic stock. Basic said that it would not have any further comment prior to Wednesday.

Basic Incorporated produces steelmaking refractories and chemical and electronic products.

* * *

BASIC INCORPORATED

Special Meeting of the Board of Directors

December 19, 1978

The Board of Directors of Basic Incorporated held a meeting at The Union Club, Cleveland, Ohio at 6:00 p.m. on Tuesday, December 19, 1978.

The following Directors were present: Messrs. H. C. Rose, H. C. Lee, E. Q. Sylvester, S. Eells, Jr., M. Muller, M. J. Ludwig and A. M. Caito. Mr. Muller presided and Mr. Ludwig kept the minutes. Waivers of notice from Messrs. Wilson and Gelbach are attached to these minutes.

Mr. Muller indicated that the purpose of the meeting was to consider an offer made earlier that day by Combustion Engineering, Inc. to acquire Basic Incorporated. Mr. Muller summarized the terms of the proposed acquisition which would be accomplished by a tender offer for all of the Common and Preference Shares of Basic at \$46.00 and \$104.55 in cash, per share, respectively. The tender offer would be made by a wholly-owned subsidiary of Combustion Engineering and would be followed, at an unspecified time, by a merger of that company and Basic in which the remaining stockholders of Basic would receive the same amount per share in cash as was offered in the tender offer.

Next, Mr. Muller asked Mr. Martin Siegel of Kidder, Peabody & Co., Incorporated to report on the conclusions of his firm concerning its valuation of Basic and its evaluation of the Combustion Engineering offer. Mr. Siegel and his colleagues distributed copies of their report to the Board, reviewed the history of the relationship between Kidder, Peabody and Basic and summarized the detailed valuation materials in the report. In summary, Mr. Siegel stated that in the opinion of his firm, the offer from Combustion Engineering was fair and equitable from a financial point of view.

The Board then discussed the offer at length. [REDACTED MATERIAL] After this discussion, the following motions were duly made by Mr. Sylvester, seconded by Mr. Eells and unanimously adopted:

RESOLVED, that the Agreement among the Company, Combustion Engineering, Inc. and CEBAS, Inc. (the "Agreement") in the form presented to this meeting, and with such changes or additions as may be approved by the President or Senior Vice President, is hereby authorized and approved.

FURTHER RESOLVED, that the officers of the Company, and each of them, are hereby authorized to enter into and carry out the Agreement, with such changes to the form thereof presented to this meeting as shall have been approved by the President or Senior Vice President, and to take such actions and execute, file, negotiate and deliver, on behalf of the Company, such other documents and instruments as any of such officers shall deem necessary or desirable in connection with the Agreement or any of the transactions or other matters provided for therein.

FURTHER RESOLVED, that the Board of Directors has determined that the tender offer provided for in the Agreement is in the best interests of the Company and hereby recommends that the Company's stockholders accept the offer and the appropriate officers of the Company are hereby authorized to take such actions and execute, file (with the Securities and Exchange Commission or otherwise) and deliver, on behalf of the Company, such documents and instruments as any such officer shall deem necessary or desirable in connection with such recommendation.

As the next item of business, Mr. Ludwig described the proposed arrangements for compensating Kidder, Peabody &

Co., Incorporated for their services in connection with the proposed transaction with Combustion Engineering. After discussion and on motion duly made, seconded and unanimously carried, the proposed compensation arrangements were approved and the

Page 3

appropriate officers were authorized to enter into and carry out a proposed letter agreement with respect to those arrangements.

Mr. Muller then left the meeting to call Messrs. Gelbach and Wilson to inform them of the results of the meeting. Upon his return, Mr. Muller informed the Board that both Messrs. Gelbach and Wilson were enthusiastically in support of the action of the Board with respect to the Combustion Engineering transaction.

There being no further business for consideration, the meeting was adjourned.

Secretary of the Meeting

In the 10-K Report and the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1978 (the "10-Q Report"), the Company reported the following consolidated financial information for the periods indicated (all amounts are in thousands, except per Common Share data):

	Year Ended December 31,		Nine Months Ended September 30,	
	1977	1976	1978	1977
			(Unaudited)	
Net Sales	\$66,746	\$65,948	\$61,420	\$54,216
Income Before Taxes and Extraordinary Items	5,112	5,751	6,504	4,823
Net Income	4,111	4,609	4,632	3,705

Income per Common Share:

Primary	2.82	3.31	3.13	2.60
Fully diluted	2.58	2.98	2.90	2.35
Shareholders' Equity	33,137	30,430	35,340	33,181

The above information taken from the 10-K Report and the 10-Q Report is qualified by reference to such reports and the financial information contained therein, including the notes accompanying the financial information. For further information concerning the Company, reference should be made to the reports and other information filed with the Commission and available at the Commission and the NTYSE.

From time to time, since October 1976, representatives of C-E have had meetings with representatives of the Company concerning the possible acquisition of the Company by C-E or an affiliate of C-E. In November 1978, in connection with discussions which led to the making of the Offer, certain financial forecasts prepared by the Company in July 1978 were furnished to representatives of C-E. Such forecasts project the Company's consolidated net sales, net income and primary income per Common Share as follows:

	Year Ended December 31,		
	1978	1979	1980
	(Amounts in thousands, except per Common Share data)		
Net Sales	\$80,340	\$90,605	\$97,360
Net Income	5,364	6,229	7,228
Primary Income per Common Share	3.59	3.97	4.44

During the discussions, representatives of the Company stated that they anticipated income per Common Share for 1978 of approximately \$5.00, rather than as set forth above. Such representatives also stated that they anticipated that income per Common Share for each of 1979 and 1980 would be approximately \$1.00 more than that forecasted in July.

The Purchaser does not assume any responsibility for the accuracy of such forecasts and believes that, because forecasts of the type furnished by the Company are inherently subject to significant uncertainties and contingencies, all of which are difficult to predict and most of which are beyond the control of the Company, there can be no assurance that the forecasted results will be realized.

8. *Certain Recent Events Related to the Offer.* On December 19, 1978, the terms of the Offer and of the Merger were negotiated and agreed upon and the Board of Directors of the Company approved the Merger and the Offer and recommended the Offer to the Company's stockholders.

On December 20, 1978, a definitive agreement for the Merger was signed. (See Section 9). Also on December 20, 1978, the Purchaser purchased 21,014 of the approximately 31,000 Common Shares owned by Max Muller, President and Chief Executive Officer of the Company, for a total consideration of \$966,644 five percent of which is payable on December 28, 1978, and the balance of which is payable on January 4, 1980. The unpaid balance will bear interest at eight percent per annum.

I have reviewed the desk calendars of Mr. Kelly for the years 1976, 1977 and 1978 and found the following references to Basic Incorporated, any off[illegible] of Basic Incorporated and/or the city of Cleveland, Ohio:

In 1976, reference to Cleveland is indicated under the dates of January 7, January 15, February 10, March 5, March 15, March 25, May 7, August 19-20, September 30, October 14, November 12, and December 6.

Under October 8 is the reference: "10/A - Brett, AJS, Dietrich, Sy Lewis, Marvin Lange" - which is probably a reference to a meeting on that day with lawyers concerning the antitrust aspects of any possible business combination with Basic.

Opposite the date of November 18 is the notation: "B of D 11/a.m." - which may be a reference to a meeting of the Board of Directors that day since the Executive Committee of the Board considered Basic on that day.

Under December 2 is the entry: "10/A Basic meeting - Perella-First Boston-LJG".

For the year 1977, reference to Cleveland is indicated under the dates of January 12, March 9, May 24, June 24, July 15, July 31-August 1, and September 7.

The notation under June 24 also says "Mueller 3/p Basic".

The empty square prior to August 1 on the calendar contains: "Home Max Mueller 216/229-8165".

The notation under August 1 includes: "Dinner Max Mueller Basic". The notation under August also has Cleveland crossed out.

For the year 1978, reference to Cleveland is indicated under February 3, February 27, May 11-13, May 19-20, May 23, June 7, July 28, October 24-25, November 27 and December 19.

Under February 27 is the additional quotation: "Basic meeting - Max Muller".

Under June 7 is the notation: "re: Basic".

Under July 14 is the notation: "First Boston 9:30A J.Perella, and A. Grassi"-which may be a reference to a meeting concerning Basic. (The desk calendar of L.J. Gross shows a meeting with J. Perella of First Boston on September 11, 1978.)

Under December 7 is the notation: "Tanya Styblas, Tom Hill, First Boston N.Y. lunch" - which may be reference to a meeting concerning Basic. (The desk calendar of L.J. Gross notes the meeting with First Boston on December 13.)

The foregoing references to Cleveland would not necessarily mean that Mr. Kelly made a trip to Cleveland or had some connection with Cleveland on that day. Conversely, not all business involving Cleveland may necessarily be reflected on the desk calendar.

Moreover, since several of the business operations which report to Mr. Kelly are located in or about Cleveland, most references to Cleveland probably do not have any relation to Basic Incorporated.

/s/ RICHARD H. TROY
Richard H. Troy

[PX Dolan 1]

UNITED STATES OF AMERICA
Before The
SECURITIES AND EXCHANGE COMMISSION

—◆—
In the Matter of
Merrill Lynch, Pierce, Fenner &
Smith, Inc., *et al.*
—◆—

AFFIDAVIT

I, David F. Dolan, depose and say as follows:

1. I reside at 32-38 75th Street, Jackson Heights, Queens, New York 11372.

2. I am employed by the New York Stock Exchange ("NYSE"), 11 Wall Street, New York, New York 10005, as a Manager, Corporate Services, and was previously a liaison representative in the Corporate Services Department. I was a representative in May 1976 and was assigned the mid-western area in April 1978. As a liaison representative of the NYSE my responsibilities include acting as a liaison between the NYSE and the companies located in my assigned geographical area. In particular, it is my duty to contact these companies whenever unusual or heavy trading activity occurs in their securities to determine if the company knows of any reason for the unusual trading activity in its securities and to report the company's response to the appropriate NYSE officials. A complete, candid response to such inquiries is expected and required so that the NYSE can discuss with a listed company the appropriators of issuing a press release issued or make a fair determination that trading in the company's securities should be halted pending a news release by the company. The consideration of these actions is necessary to insure that a fair and orderly market is maintained in the company's securities.

3. During 1978, Basic, Inc. ("Basic") was listed and its securities traded on the NYSE. It was one of the companies assigned to me as liaison representative for the mid-western area. Mr. Theodore Thomas, Secretary and Treasurer of Basic, was the key contact at Basic and as such the officer at Basic I contacted whenever I needed to direct an inquiry to Basic.

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4. It is a NYSE policy that a corporation, the stock of which is listed on the NYSE, is expected to promptly release to the public any news or information which might reasonably be expected to materially affect the market for its securities. This policy is more fully set forth in the NYSE's Expanded Policy on Time Disclosure (Ex. A).

5. On July 14, 1978, Basic common stock increased in price. By 2:52 pm of that day it was up \$3¹/₈ per share to \$26⁷/₈, a new high price for Basic for 1978, on volume of 18,200 share. As a result of the increase in price and volume, Mr. Frank A. Delaney, a NYSE Floor Official, requested that the Stock Watch Department of the NYSE initiate an inquiry into the trading activity. The Stock Watch Department checked the trading in Basic common stock, the trading in the stock of other companies in the same industry and news releases, if any, by Basic during the past ninety (90) days were reviewed. This information was placed on a Stock Watch Form dated July 14, 1978 (Ex. B).

6. Upon receiving the Stock Watch Form, I initiated a telephone inquiry to Basic at 3:00 pm, July 14, 1978, to determine if the company knew of any reason to explain the trading activity in its common stock. I reached Mr. Thomas, informed him of the trading activity, and asked if Basic was aware of any corporate developments to explain the trading activity. Mr. Thomas replied that he could not attribute the trading activity to any corporate activities and that there were no corporate developments which would account for such activity. The Stock Watch Form, Ex. B, contains a list of areas to be inquired into during such calls including "undisclosed

merger or acquisition plans." It is my procedure to review this list and inquire of the corporate officer about each of these areas including any undisclosed merger or acquisition plans. In this case, Mr. Thomas responded that there were no corporate developments.

7. Following the telephone call to Mr. Thomas I noted Mr. Thomas' response on Ex. B, signed the form and returned it.

8. On September 25, 1978, Basic common stock increased in price \$2 $\frac{1}{2}$ per share to \$32 $\frac{7}{8}$ per share on volume of 28,500 shares by 11:25 a.m. Mr. William W. Prager, Jr., a NYSE Floor Governor, requested that Basic be contacted concerning the unusual

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volume and price activity, and that if there were no corporate developments to explain the activity that the NYSE ask the company to issue a press release to that effect. This request was initiated by his contacting an individual in the Stock Watch-On-Line Area, who completed a Stock Watch-On-Line Alert Report dated September 25, 1978 (Ex. C).

9. Pursuant to Mr. Prager's request, the Stock Watch Department checked the recent trading in Basic stock, its last quarterly earnings report, noted Mr. Prager's request for a news release from Basic and relayed this information to the Corporate Services Department, where a Stock Watch Form dated September 25, 1978 (Ex. D) 11:25 a.m. was completed.

10. At 11:30 a.m. on September 25, 1978, I initiated a telephone inquiry to Basic and spoke to Mr. Mathew Ludwig, Senior Vice-President-Finance, at Basic. I explained the trading activity and asked Mr. Ludwig if there were any corporate developments to explain the unusual trading activity in Basic's common stock. Mr. Ludwig said there were no corporate developments to explain the trading activity and that he was considering calling the specialist in Basic stock. I requested of Mr. Ludwig that since there were no corporate developments, that Basic issue a press release to that effect and he responded that he would consider the request and probably would issue

such a release. I noted Mr. Ludwig's response on Ex. D, signed the Stock Watch Form (Ex. D) and returned it.

11. On December 15, 1978, the price of Basic common stock increased \$2 $\frac{1}{4}$ per share to \$30 $\frac{1}{8}$ per share on volume of 58,400 shares. The Stock Watch-On-Line Area of the Stock Watch Department noted the unusual activity in Basic on a Stock Watch-On-Line Alert Report dated December 15, 1978. (Ex. E).

12. The Stock Watch-On-Line Area then relayed the information to the Corporate Services Department, where Stock Watch Form dated December 15, 1978 at 12:10 (Ex. F) was completed. This information was recorded on Exhibit F.

13. Pursuant to the Stock Watch Form (Ex. F), I initiated a telephone call to Basic at 12:10 p.m. on December 15, 1978

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to determine if there were any corporate developments to explain the unusual activity in the company's stock. I was told that Messrs. Thomas Ludwig and Max Muller, President of Basic, were at a luncheon, that was unrelated to Basic's business or the market activity, and that they could not be reached at that moment. I left my name and telephone number and asked that my telephone call be returned. At 2:25 p.m. of the same day, Mr. Thomas returned my telephone call. I explained the market activity in Basic stock and asked him if there were any corporate developments to explain the unusual market activity. He stated that the company knew of no reason for the market activity and that there were no corporate developments to explain such market activity. I went through the list of areas to be inquired of on the Stock Watch Form including "undisclosed merger or acquisition plans." It is my procedure to review this list and inquire of the corporate office about each of these areas including, undisclosed merger or acquisition plans. In each case Mr. Thomas responded there were no corporate developments. I noted my conversation with Mr. Thomas on the Stock Watch Form (Ex. F), signed and returned it.

14. On Monday, December 18, 1978, at 9:45 a.m., Basic released a news announcement stating that an unnamed company wanted to acquire Basic. The opening of trading in Basic's securities was delayed based upon this news release. Trading reopened in Basic's securities on December 19, 1978 at 12:05 p.m. on a volume of 32,300 shares at a price of \$45.

15. Sometime during the period of December 18 through December 20, I spoke with Mr. Thomas and he stated that he was not personally aware of the merger discussions and that he was not privy to any negotiations between Basic and any other company.

16. Exhibit A is a full text of the NYSE Expanded Policy on Timely Disclosure.

17. Exhibit B is a NYSE Stock Watch Form dated July 14, 1978 at 2:52.

18. Exhibit C is a NYSE Stock Watch-On-Line Alert Report dated September 25, 1978 at 11:07 a.m.

19. Exhibit D is a NYSE Stock Watch Form dated September 25, 1978 at 11:25 a.m.

20. Exhibit E is NYSE Stock Watch On Line Alert Report dated December 15, 1978 at 12:07 p.m.

21. Exhibit F is NYSE Stock Watch Form dated December 15, 1978 at 12:10.

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I CERTIFY THAT THE ABOVE IS TRUE AND CORRECT TO THE BEST OF MY KNOWLEDGE.

/s/ DAVID F. DOLAN
David F. Dolan

SUBSCRIBED AND SWORN TO BEFORE ME, the undersigned authority, this *[illegible]* day of *[illegible]* 1980.

/s/ *[Illegible]*
NOTARY PUBLIC

Notary Public State of New York
No. 24-4699501

Certified in Kings County
Commission expires March 30, 1988
My commission expires: _____

(Note: material in brackets is handwritten.)

EXPANDED POLICY ON TIMELY DISCLOSURES

THE NEW YORK STOCK EXCHANGE
11 Wall Street, New York, New York 10005

SECTION A 2

LISTING AGREEMENTS

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SECTION A 2

Part I

TIMELY DISCLOSURE

Timely and Adequate Disclosure of Corporate News

A corporation whose stock is listed on the New York Stock Exchange is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities. This is one of the most important and fundamental purposes of the listing agreement which each corporation enters into with the Exchange. The agreement is discussed in greater detail in the latter part of this Section beginning on page [A-27].

A corporation should also act promptly to dispel unfounded rumors which result in unusual market activity or price variations."

The discussion which follows will assist a listed corporation in making adequate and timely disclosure to its shareholders, the financial community, and the investing public and thus provide the basis for a market for its securities which will be fair to all participants.

Exchange Market Surveillance

For its part, the Exchange maintains a continuous market surveillance program through its Division of Stock Watch. The program is designed to closely review the markets in those securities in which unusual price and volume changes occur or where there is a large unexplained influx of buy or sell orders. Under such circumstances, the Company may be called by a member of the Department of Stock List to inquire about any company developments which have not been publicly announced but which could be responsible for unusual market activity. Where the market appears to be reflecting undisclosed information, the Corporation will normally be requested to make it public immediately. Occasionally it may be necessary

to carry out a stock watch inquiry after the fact and the Exchange may request such information from the Company as may be necessary to complete such an inquiry.

The listing agreement provides that the Corporation will furnish to the Exchange on demand such information concerning the Corporation as the Exchange may reasonably require.

Listing Representative—Department of Stock List

Each listed company is assigned to a Listing Representative who is a member of the staff of the Department of Stock List. This representative serves as the liaison point for the Corporation and the Exchange. When the assigned representative is not available, another member of the staff will handle any inquiry, request, or report so that there will be no unnecessary delay in attending to listed company matters. The Secretary of the corporation is kept advised of the person serving in this capacity.

Preliminary discussions on important matters may be undertaken by listed company officials with the assurance that extreme security measures have been adopted by the Exchange to avoid revealing any confidential information which a listed company may disclose.

Internal Handling of Confidential Corporate Matters

Unusual market activity or a substantial price change has on occasion occurred in a company's securities shortly before the announcement of an important corporate action or development. Such incidents are extremely embarrassing and damaging to both the Company and the Exchange since the public may quickly conclude that someone acted on the basis of "inside" information.

Negotiations leading to acquisitions and mergers, stock splits, the making of arrangements preparatory to an exchange or tender offer, changes in dividend rates or earnings, calls for redemption, new contracts, products, or discoveries, are the type of developments where the risk of untimely and inadvertent disclosure of corporate plans is most likely to occur.

Frequently, these matters require discussion and study by corporate officials before final decisions can be made. Accordingly, extreme care must be used in order to keep the information on a confidential basis.

WHERE IT IS POSSIBLE TO CONFINE FORMAL OR INFORMAL DISCUSSIONS TO A SMALL GROUP OF THE TOP MANAGEMENT OF THE COMPANY OR COMPANIES INVOLVED, AND THEIR INDIVIDUAL CONFIDENTIAL ADVISORS WHERE ADEQUATE SECURITY CAN BE MAINTAINED, PREMATURE PUBLIC ANNOUNCEMENT MAY PROPERLY BE AVOIDED. In this regard, the market action of a company's securities should be closely watched at a time when consideration is being given to important corporate matters. If unusual market activity should arise, the Company should be prepared to make an immediate public announcement of the matter.

At some point it usually becomes necessary to involve other persons to conduct preliminary studies or assist in other preparations for contemplated transactions, e.g., business appraisals, tentative financing arrangements, attitude of large outside holders, availability of major blocks of stock, engineering studies, market analyses and surveys, etc. Experience has shown that maintaining security at this point is virtually impossible. Accordingly, fairness requires that the Company make an immediate public announcement as soon as confidential disclosures relating to such important matters are made to "outsiders."

The extent of the disclosures will depend upon the stage of discussion, studies, or negotiations. So far as possible, public statements should be definite as to price, ratio, timing and/or any other pertinent information necessary to permit a reasonable evaluation of the matter. As a minimum, they should include those disclosures made to "outsiders." Where an initial announcement cannot be specific or complete, it will need to be supplemented from time to time as more definitive or different terms are discussed or determined.

Corporate employees, as well as directors and officers, should be regularly reminded as a matter of policy that they

must not disclose confidential information they may receive in the course of their duties and must not attempt to take advantage of such information themselves.

In view of the importance of this matter and the potential difficulties involved, the Exchange suggests that a periodic review be made by each company of the manner in which confidential information is being handled within its own organization. A reminder notice of the Company's policy to those in sensitive areas might also be helpful from time to time.

The effective implementation of the foregoing is essential to the maintenance of a fair and orderly securities market for the benefit of a company and its shareholders. It should minimize the occasions where the Exchange finds it necessary to temporarily halt trading in a security due to information leaks or rumors in connection with significant corporate transactions.

While the procedures are directed primarily at situations involving two or more companies, they are equally applicable to major corporate developments involving a single company. Announcements of this type should usually be handled by telephone alert to the Department of Stock List.

Relationship Between Company Officials and Security Analysts, Institutional Investors, etc.

Security analysts play an increasingly important role in the evaluation and interpretation of the financial affairs of listed companies. Annual reports, quarterly reports, and interim releases cannot by their nature provide all of the financial and statistical data that should be available to the investing public. The Exchange recommends that corporations observe an "open door" policy in their relations with security analysts, financial writers, shareowners, and others who have a legitimate investment interest in the company's affairs.

A company should not give information to one inquirer which it would not give to another. Nor should it reveal information it would not willingly give to the press for publication. Thus, for corporations to give advance earnings, dividend, stock split, merger, or tender information to analysts,

whether representing an institution, brokerage house, investment advisor, large stockholder, or anyone else, would be clearly incompatible with Exchange policy. On the other hand, it should not withhold information in which analysts or other members of the investing public have a warrantable interest.

If during the course of a discussion with analysts substantive material not previously published is disclosed, that material should be simultaneously released to the public. The various security analysts societies usually have a regular procedure to be followed where formal presentations are made. The company should follow these same precautions when dealing with groups of industry analysts in small or closed meetings.

The competent analyst depends upon his professional skills and broad industry knowledge in making his evaluations and preparing his reports and does not need the type of inside information that could lead to unfairness in the marketplace.

Relationship Between Company Officials and Exchange Specialists

The specialist is charged with doing all that is in his power to give the company and its stockholders the fair and orderly market that is expected from a listing on the Exchange. To do this effectively, he must maintain proper liaison with the company's officials. Properly conducted, such liaison should foster a mutually beneficial understanding of the problems encountered by both. Company officials should be kept informed of any unusual market problems and are free to call on the specialist for information if a question arises about the market in the stock. The specialist, for his part, gains from a better understanding of the company and its affairs.

There is, of course, a point beyond which it would be improper for the company to go in giving information to the specialist. Thus, for the corporation to give advance earnings, dividend, stock split, or merger information to a specialist or anyone else would be clearly inappropriate. On the other hand, it is entirely appropriate for company officials to discuss such matters as the trend of business with the specialist, much as

they would with bankers, stockholders, security analysts, or anyone having a legitimate interest in the company. In this way, the specialist may be better able to maintain a market beneficial to the company and its present and prospective stockholders.

A booklet entitled "The Specialist" is available from the Exchange on request of listed companies.

Relationship Between Company Officials and Personnel of New York Stock Exchange Member Organizations Serving as Directors or Advisors to the Corporation

The following excerpt from Member Firm Educational Circular No. 162 of June 22, 1962 sets forth Exchange policy in these relationships:

"Every director has a fiduciary obligation not to reveal any privileged information to anyone not authorized to receive it. Not until there is full public disclosure of such data, particularly when the information might have a bearing on the market price of the securities, is a director released from the necessity of keeping information of this character to himself. Any director of a corporation who is a partner, officer, or employee of a member organization should recognize that his first responsibility in this area is to the corporation on whose Board he serves. Thus, a member firm director must meticulously avoid any disclosure of inside information to his partners, employees of the firm, his customers or his research or trading departments."

Where a representative of a member organization is not a director but is acting in an advisory capacity to a company and discussing confidential matters, the ground rules should be substantially the same as those that apply to a director. Should the matter require consultation with other personnel of the organization, adequate measures should be taken to guard the confidential nature of the information to prevent its mis-use within or outside of the member organization.

A booklet entitled, "The Corporate Director and The Investing Public" is available from the Exchange on request of listed companies.

PART II

PROCEDURE FOR PUBLIC RELEASE OF INFORMATION

Immediate Release Policy

The normal method of publication of important corporate data is by means of a press release. This may be either by telephone or in written form. Any release of information that could reasonably be expected to have an impact on the market for a company's securities should be given to the wire services and the press FOR IMMEDIATE RELEASE. Clearly, a corporation cannot properly assume responsibility for the security of such important information in the hands of persons or organizations beyond its control.

The spirit of the IMMEDIATE RELEASE policy is not considered to be violated on weekends where a "Hold for Sunday or Monday A.M.'s" is used to obtain a broad public release of the news. This procedure facilitates the combination of a press release with a mailing to shareholders.

Annual and quarterly earnings, dividend announcements, acquisitions, mergers, tender offers, stock splits, and major management changes are examples of news items that should be handled on an immediate release basis. News of major new products, contract awards, expansion plans, and discoveries very often fall into the same category. Unfavorable news should be reported as promptly and candidly as the favorable. Reluctance or unwillingness to release a negative story or an attempt to disguise unfavorable news endangers a management's reputation for integrity. Changes in accounting methods to mask such occurrences can have a similar long-term impact.

It should be a corporation's primary concern to assure that news will be handled in proper perspective. This necessitates appropriate restraint, good judgment, and careful adherence to

the facts. Any projection of financial data, for instance, should be soundly based, appropriately qualified, conservative and factual. Excessive or misleading conservatism should be avoided. Likewise, the repetitive release of essentially the same information is not appropriate.

Few things are more damaging to a corporation's stockholder relations or to the general public's regard for corporate securities than information improperly withheld whether inadvertently or willfully. On the other hand, a mere deluge of press releases is not to be used since important items can become confused with trivia.

Premature announcements of new products whose commercial application cannot yet be realistically evaluated should be avoided. So should overly optimistic forecasts, exaggerated claims and unwarranted promises. And should subsequent developments indicate that performance will not match earlier projections, this too should be reported and explained.

Judgment must be exercised as to the timing of a public release on those corporate developments where the immediate release policy is not involved or where disclosure would endanger the company's goals or provide information helpful to a competitor. In these cases, it is helpful to weigh the fairness to both present and potential stockholders who at any given moment may be considering buying or selling the company's stock.

Dealing with Rumors or Unusual Market Activity

The market action of a company's securities should be closely watched at a time when consideration is being given to significant corporate matters. If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required. If rumors are in fact false or inaccurate, they should be promptly denied or clarified. If they are correct, however, an immediate, candid statement to the public as to the state of negotiations or the state of development of corporate plans in the rumored area must be made directly and openly. Such statements are essential despite the business inconvenience

which may be caused and even though the matter may not as yet have been presented to the company's Board of Directors for consideration.

TELEPHONE ALERT TO THE DEPARTMENT OF STOCK LIST OF THE EXCHANGE

When the announcement of news of a material event or a statement dealing with a rumor which calls for IMMEDIATE RELEASE is made shortly before the opening or during market hours (normally 10 a.m. to 3:30 p.m., New York time), it is recommended that the Department of Stock List of the Exchange be notified by telephone no later than simultaneously with the release of the announcement to the news media. If the Exchange receives such notification in time, it will be in a position to consider whether, in the opinion of the Exchange, trading in the security should be halted temporarily. A delay in trading, which normally would last about 15 minutes after the appearance of the news on the Dow-Jones news ticker, provides a period for the public evaluation of the announcement. A longer delay in trading may be necessary if there is an unusual influx of orders. The Exchange attempts to keep such interruptions in the continuous auction market to a minimum. However, where events transpire during market hours, the overall importance of fairness to all those participating in the market demands that these procedures be followed. Normally, the call should be directed to the Listing Representative assigned to the Company. A telephone alert should be confirmed promptly in writing.

Release to Newspapers and News Wire Services

News which ought to be the subject of immediate publicity must be released by the fastest available means. The "fastest available means" may vary in individual cases and according to the time of day. Ordinarily, this requires a release to the public press by telephone, telegraph, or hand delivery, or some combination thereof. Transmittal of such a release to the press solely by mail is not considered satisfactory. Similarly, release of such

news exclusively to the local press outside of New York City would not be sufficient for adequate and prompt disclosure to the investing public.

To insure adequate coverage, releases requiring immediate publicity should be given to Dow Jones & Company, Inc., to Reuters Economic Services, and to Associated Press and United Press International. These releases should also be given to one or more of the newspapers of general circulation in New York City which regularly publish financial news.

The foregoing distribution of releases should be regarded as a minimum. Many companies may wish to give additional prompt distribution of their releases, particularly to newspapers in cities where the company is headquartered or has plants or other major facilities.

Two copy of any such press release should be sent promptly to the Exchange, to the attention of the Department of Stock List.

The New York City addresses and telephone numbers of these national news-wire services are:

Associated Press, 50 Rockefeller Plaza, 262-8125; after 7:00 p.m., 262-6071-2-3 or 4.

Dow Jones & Company, Inc., 22 Cortlandt St., 285-5178-86; after 5:45 p.m., 285-5000.

Reuters Economic Services, 1700 Broadway, 581-4250; after 6:30 p.m., 582-4030.

United Press International, 220 East 42 Street, MUrray Hill 2-0400, Ext. 371; after 6:00 p.m., Ext. 325.

It is suggested that every news release include the name and telephone number of a company official who will be available if a newspaper or news wire service desires to confirm or clarify the release with the company.

Part III

DIRECTOR AND OFFICER STOCK TRANSACTIONS

Many stockholders feel that directors and officers should have a meaningful investment in the companies they manage. The extent of this ownership, naturally, would vary in accordance with the financial circumstances of the persons involved. As shareowners themselves, directors are more likely to represent the viewpoint of other shareowners whose interests they are charged with protecting. Similarly, officers—the executive management group—may well perform more effectively with the incentive of stock options or a share in the equity ownership of the corporation.

The Exchange has encouraged the broadening of shareownership through stock option and employee stock purchase plans, especially those plans that include all or a large portion of the company's employees. The approval of stockholders has been a prerequisite of Exchange listing of new shares for the more limited key officer plans.

However, the widespread endorsement of director and officer shareownership brings with it questions that concern the timing of their stock transactions. When may a director or officer properly buy or sell shares of his company's stock? When is it appropriate to award stock options to key executives? There is no simple, uniform answer to these questions, but they do underscore the importance of a policy of adequate and timely disclosure both for the benefit of the investing public and for the protection of management.

Competition requires that companies engage in active programs of research, development, and exploration. For many companies, more than half of today's sales represent new products or services invented, discovered, developed, or radically redesigned during the last ten years. Nevertheless, more experimental projects fail than result in salable and profitable products or services. Public disclosure at the earlier stages of new developments may be premature. In addition, competition and the best interests of the company and its shareholders may require a veil of secrecy around new developments before they

reach the stage where public disclosure is appropriate. Still, hindsight is remarkably keen and the accusation can always be made that a purchase or sale of stock by a director was dictated by inside knowledge of a future favorable or unfavorable development. *This theory, carried to its extreme, might suggest that a corporate official should never buy or sell stock in the company he represents.*

But to reiterate, stockholders have indicated that they want officers and directors to have a meaningful investment in the companies they manage. So, in the interest of promoting better stockholder relationships, some rule of thumb under which corporate officials may properly buy or sell stock in their company would be helpful. Considerations which may be pertinent in approaching this question are outlined in the paragraphs which follow.

1. One appropriate method of purchase might be a periodic investment program where the officer or director makes regular purchases under an established program administered by a broker and where the timing of purchases is outside the control of the individual.
2. It would also seem appropriate for officials to buy or sell stock in their companies for a 30-day period commencing one week after the annual report has been mailed to stockholders and otherwise broadly circulated (provided, of course, that the annual report has adequately covered important corporate developments and that no new major undisclosed developments occur within that period).
3. Transactions may also be appropriate under the following circumstances, provided that prior to making a purchase or sale an officer or director contacts the chief executive officer of the company to find out if there are any important developments pending which need to be made public before an insider could properly participate in the market.

- (a) Following a release of quarterly results, which includes adequate comment on new developments during the period. This timing of transactions might be even more appropriate where the report has been mailed to shareowners.
- (b) Following the wide dissemination of information on the status of the company and current results. For example, after a proxy statement or prospectus which gives such information in connection with a merger or new financing.
- (c) At those times when there is relative stability in the company's operations and the market for its securities. Under these circumstances, timing of transactions may be relatively less important. Of course such periods of relative stability will vary greatly from time to time and will also depend to a large extent on the nature of the industry or the company.

If the size of a purchase or sale is substantial, say more than \$30,000 within a 3-month period, the preferable course of action might be to make such a purchase or sale in the time period outlined in (2) above.

Where a development of major importance is expected to reach the appropriate time for announcement within the next few months, transactions by officers and directors should probably be avoided.

Corporate officials should wait until after the release of earnings, dividends, or other important developments has appeared in the press before making a purchase or sale. This permits the news to be widely disseminated and negates the inference that officials had an inside advantage. Similarly, transactions just prior to important press releases should probably be avoided.

In granting stock options to key officers and directors, the same philosophy that relates to purchases and sales may well apply. Where an established pattern or formula is part of a

plan specifically approved by shareholders, the question of timing may not arise. In taking up an option, the timing of a purchase is not usually critical as the price is set at the time the option is granted. The reasoning relating to stock options might also apply to employee stock purchase plans in which officers and directors may be entitled to participate.

The considerations that affect officer and director transactions in stock of their own company may be pertinent to transactions in the shares of other companies with whom discussions of acquisition, merger, or important contracts, etc., are being considered or carried on.

The same considerations apply to the families or close associates of officers and directors who are often presumed to have preferential access to information. As far as the public is concerned, these also are insiders. And while this assumption may be unjustified in many cases, it is a fact of life which those in positions of leadership and responsibility cannot ignore.

Some companies have adopted policies for the guidance of their personnel relating to transactions in the company's stock, as well as other areas where conflicts of interest could arise. Such policies can be very helpful to employees who have access to important confidential information, as well as to the officers and directors.

In the final analysis, directors and officers must be guided by a sense of fairness to all segments of the investing public.

Within the framework of any policies adopted by his company, the final decision of each officer and director with respect to securities transactions must be his own. Each case must ultimately stand or fall on its own merits. No single rule could possibly cover all situations; nor should unnecessary restrictions be permitted to discourage shareowners among these business leaders who play such a vital role in the success of our system of free enterprise.

Particular attention is directed to Section 10b and 16 of the Securities Exchange Act of 1934 and rule 10b-5 of the Securities and Exchange Commission.

PART IV

LISTING AGREEMENT

Development of the Listing Agreement

Since 1899, companies making application for the listing of their securities have, as a regular part of the listing procedure, entered into a Listing Agreement with the Exchange by which they commit themselves to a code of performance, after listing, in respect of the matters dealt with by the agreement.

At the outset the items in the agreement were few in number, and restricted in scope. Initially there were only three, two of which were concerned with mechanical necessities of the market-place—the maintenance of transfer facilities and advance notice of record dates.

The third item represented the Exchange's effort to satisfy, by a formal requirement, a public need which it had long recognized, but which its previous, unsupported efforts had been unable to fill—the need of investors for regular financial reports by the companies whose securities they held. Supported by a rising popular demand for such information and the beginning of a show of interest by corporate managements, the Exchange sought, through the medium of the newly-born listing agreement, to make the regular publication of annual financial statements a standard practice among listed companies. Now, with almost all listed companies publishing quarterly reports of earnings, it is interesting to note that in 1866, the Exchange, when requesting financial statements of a well-known company of that day, was told by the company that it "made no reports and published no statements and had not done anything of the kind for the last five years."

From that beginning, as corporate policies and practices, and those of the securities industry, advanced and grew more complex, and as the areas of warrantable public interest in corporate affairs broadened and became more clearly defined, the listing agreement advanced, and expanded in scope as well as in number of requirements.

While that expansion, as measured from its beginning in 1899, has been considerable, it has also been gradual, in pace with the development of public policy in the fields of corporation finance and management, and in the fields of stockholder relations and accounting. New requirements have been added only as the need for remedial measures and the appropriate, practical means of applying those measures became evident, or as they became useful in promotion of a trend toward improved practice among leading corporations. It has been gradual because the Exchange, through the years, as now, has been loath to adopt any new requirement affecting listed companies until that requirement has been proved to be not only sound in principle, and an advancement of the public interest, but thoroughly workable, as well.

Current Agreement as a Guide

One result of the evolutionary process by which the listing agreement has developed is that not all companies have an identical agreement with the Exchange. The listing agreement as a whole is only renewed upon the occasion of an application for listing, and the exact form of the agreement executed by any one company depends upon just when it last made an application for listing any of its securities, and upon the form of agreement then standard.

However, the form of agreement now standard (which is reproduced below in this Section of the Manual) is indicative of current concepts of good practice, and of what is currently necessary or desirable, in respect to the matters with which it deals. The Exchange urges every listed company to be guided by the current standard form of agreement in the matters on which it bears, even though the specific agreement last executed by it may have been less comprehensive.

One of the most important and fundamental purposes and intents of the agreement, in combination with other procedures and policies of the Exchange, is to assure that adequate and timely publicity is given to matters concerning listed companies of significance to the investing public. Reports made to the

Exchange pursuant to the listing agreement may be made available to the public and the press by the Exchange. However, the Exchange normally expects a corporation to handle all of its own press releases.

The principles underlying the agreement may also be useful as a guide in matters not specifically covered by it. In order to make it generally applicable, and to hold the requirements within a reasonable number, it is restricted to matters of more or less common occurrence in the affairs of large, publicly-owned companies. In all probability there will arise, from time to time, unusual situations, not specifically covered by any paragraph of the agreement. The Exchange urges listed companies to be guided in such situations, by the principles exhibited by the listing agreement.

Objectives of the Agreement

Upon study of the current form of listing agreement, as reproduced below, it will become evident that, in general, it seeks to achieve the following objectives:

1. Timely disclosure, to the public and to the Exchange, of information that may affect security values or influence investment decisions, and in which stockholders, the public and the Exchange have a warrantable interest; (see detailed discussion of this subject in the first part of this Section beginning on page A-20).
2. Frequent, regular and timely publication of financial reports prepared in accordance with accepted accounting practice, and in adequate (but not burdensome) detail;
3. Providing the Exchange with timely information to enable it to perform, efficiently and expeditiously, its function of maintaining an orderly market for the company's securities and to enable it to maintain its necessary records;
4. Preclusion of certain practices not generally considered sound;

5. Allowing the Exchange opportunity to make representations as to certain matters before they become accomplished facts.

On the basis of more than fifty years experience with the listing agreement, and constant study of its effect, the Exchange believes that the assurance investors derive from the agreement, and from the demonstration of intention corporate management makes in assuming the obligations of the agreement, contributes substantially to the marked preference shown by the public for securities listed on the New York Stock Exchange.

Administration of the Agreement

Naturally, the Exchange looks for strict observance of the listing agreement. However, it is realized that, occasionally, conditions will arise which make literal compliance with one, or another, of its requirements difficult, if not impossible. In such a case the Exchange is inclined to place the emphasis upon the spirit, rather than upon the letter, of the agreement, and will endeavor to work out with the company some way of relieving the difficulty, while preserving the purpose of the agreement.

If, in a particular situation, it should appear that there may be some difficulty in compliance with a particular requirement of the agreement, the matter should be brought to the attention of the Department of Stock List of the Exchange as soon as the possibility of difficulty becomes apparent.

Current Form of Listing Agreement

Nothing in the following Agreement shall be so construed as to require the Issuer to do any acts in contravention of law or in violation of any rule or regulation of any public authority exercising jurisdiction over the Issuer.

..... (hereinafter called the "Corporation"), in consideration of the listing of the securities covered by this application, hereby agrees with the New York Stock Exchange (hereinafter called the "Exchange"), as follows:

I

1. The Corporation will promptly notify the Exchange of any change in the general character or nature of its business.

2. The Corporation will promptly notify the Exchange of any changes of officers or directors.

3. The Corporation will promptly notify the Exchange in the event that it or any company controlled by it shall dispose of any property or of any stock interest in any of its subsidiary or controlled companies, if such disposal will materially affect the financial position of the Corporation or the nature or extent of its operations.

4. The Corporation will promptly notify the Exchange of any change in, or removal of, collateral deposited under any mortgage or trust indenture, under which securities of the Corporation listed on the Exchange have been issued.

5. The Corporation will:

- a. File with the Exchange four copies of all material mailed by the Corporation to its stockholders with respect to any amendment or proposed amendment to its Certificate of Incorporation.
- b. File with the Exchange a copy of any amendment to its Certificate of Incorporation, or resolution of Directors in the nature of an amendment, certified by the Secretary of the state of incorporation, as soon as such amendment or resolution shall have been filed in the appropriate state office.
- c. File with the Exchange a copy of any amendment to its By-Laws, certified by a duly authorized officer of the Corporation, as soon as such amendment shall have become effective.

6. The Corporation will disclose in its annual report to shareholders, for the year covered by the report, (1) the number of shares of its stock issuable under outstanding options at the beginning of the year; separate totals of changes

in the number of shares of its stock under option resulting from issuance, exercise, expiration or cancellation of options; and the number of shares issuable under outstanding options at the close of the year, (2) the number of unoptioned shares available at the beginning and at the close of the year for the granting of options under an option plan, and (3) any changes in the exercise price of outstanding options, through cancellation and reissuance or otherwise, except price changes resulting from the normal operation of anti-dilution provisions of the options.

7. The Corporation will report to the Exchange, within ten days after the close of a fiscal quarter, in the event any previously issued shares of any stock of the Corporation listed on the Exchange have been reacquired or disposed of, directly or indirectly, for the account of the Corporation during such fiscal quarter, such report showing separate totals of acquisitions and dispositions and the number of shares of such stock so held by it at the end of such quarter.

8. The Corporation will promptly notify the Exchange of all facts relating to the purchase, direct or indirect, of any of its securities listed on the Exchange at a price in excess of the market price of such security prevailing on the Exchange at the time of such purchase.

9. The Corporation will not select any of its securities listed on the Exchange for redemption otherwise than by lot or pro rata, and will not set a redemption date earlier than fifteen days after the date corporate action is taken to authorize the redemption.

10. The Corporation will promptly notify the Exchange of any corporate action which will result in the redemption, cancellation or retirement, in whole or in part, of any of its securities listed on the Exchange, and will notify the Exchange as soon the Corporation has notice of any other action which will result in any such redemption, cancellation or retirement.

11. The Corporation will promptly notify the Exchange of action taken to fix a stockholders' record date, or to close the transfer books, for any purpose, and will take such action at such time as will permit giving the Exchange at least ten days' notice in advance of such record date or closing of the books.

12. In case the securities to be listed are in temporary form, the Corporation agrees to order permanent engraved securities within thirty days after the date of listing.

13. The Corporation will furnish to the Exchange on demand such information concerning the Corporation as the Exchange may reasonably require.

14. The Corporation will not make any change in the form or nature of any of its securities listed on the Exchange, nor in the rights or privileges of the holders thereof, without having given twenty days' prior notice to the Exchange of the proposed change, and having made application for the listing of the securities as changed if the Exchange shall so require.

15. The Corporation will make available to the Exchange, upon request, the names of member firms of the Exchange which are registered owners of stock of the Corporation listed on the Exchange if at any time the need for such stock for loaning purposes on the Exchange should develop, and in addition, if found necessary, will use its best efforts with any known large holders to make reasonable amounts of such stock available for such purposes in accordance with the rules of the Exchange.

16. The Corporation will promptly notify the Exchange of any diminution in the supply of stock available for the market occasioned by deposit of stock under voting trust agreements or other deposit agreements, if knowledge of any such actual or proposed deposits should come to the official attention of the officers or directors of the Corporation.

17. The Corporation will make application to the Exchange for the listing of additional amounts of securities listed on the Exchange sufficiently prior to the issuance thereof to permit action in due course upon such application.

II

1. The Corporation will publish at least once a year and submit to its stockholders at least fifteen days in advance of the annual meeting of such stockholders and not later than three months after the close of the last preceding fiscal year of the Corporation a balance sheet as of the end of such fiscal year, and a surplus and income statement of such fiscal year of the Corporation as a separate corporate entity and of each corporation in which it holds directly or indirectly a majority of the equity stock; or in lieu thereof, eliminating all intercompany transactions, a consolidated balance sheet of the Corporation and its subsidiaries as of the end of its last previous fiscal year, and a consolidated surplus statement and a consolidated income statement of the Corporation and its subsidiaries for such fiscal year. If any such consolidated statement shall exclude corporations a majority of whose equity stock is owned directly or indirectly by the Corporation: (a) the caption of, or a note to, such statement will show the degree of consolidation; (b) the consolidated income account will reflect, either in a footnote or otherwise, the parent company's proportion of the sum of, or difference between, current earnings or losses and the dividends of such unconsolidated subsidiaries for the period of the report; and (c) the consolidated balance sheet will reflect, either in a footnote or otherwise, the extent to which the equity of the parent company in such subsidiaries has been increased or diminished since the date of acquisition as a result of profits, losses and distributions.

Appropriate reserves, in accordance with good accounting practice, will be made against profits arising out of all transactions with unconsolidated subsidiaries in either parent company statements or consolidated statements.

Such statements will reflect the existence of any default in interest, cumulative dividend requirements, sinking fund or redemption fund requirements of the Corporation and of any controlled corporation, whether consolidated or unconsolidated.

2. All financial statements contained in annual reports of the Corporation to its stockholders will be audited by independent public accountants qualified under the laws of some state or country, and will be accompanied by a copy of the certificate made by them with respect to their audit of such statements showing the scope of such audit and the qualifications, if any, with respect thereto.

The Corporation will promptly notify the Exchange if it changes its independent public accountants regularly auditing the books and accounts of the Corporation.

3. All financial statements contained in annual reports of the Corporation to its stockholders shall be in the same form as the corresponding statements contained in the listing application in connection with which this Listing Agreement is made, and shall disclose any substantial items of unusual or non-recurrent nature.

4. The Corporation will publish quarterly statements of earnings on the basis of the same degree of consolidation as in the annual report. Such statements will disclose any substantial items of unusual or non-recurrent nature and will show either net income before and after federal income taxes or net income and the amount of federal income taxes.

5. The Corporation will not make, nor will it permit any subsidiary directly or indirectly controlled by it to make, any substantial charges against capital surplus, without notifying the Exchange. If so requested by the Exchange, the Corporation will submit such charges to stockholders for approval or ratification.

6. The Corporation will not make any substantial change, nor will it permit any subsidiary directly or indirectly controlled by it to make any substantial change, in accounting methods, in policies as to depreciation and depletion or in bases of valuation of inventories or other assets, without notifying the Exchange and disclosing the effect of any such change in its next succeeding interim and annual report to its stockholders.

III

1. The Corporation will maintain in the Borough of Manhattan, City of New York, in accordance with the requirements of the Exchange:

a. An office or agency where the principal of and interest on all bonds of the Corporation listed on the Exchange shall be payable and where any such bonds which are registerable as to principal or interest may be registered.

b. An office or agency where

(1) All stock of the Corporation listed on the Exchange shall be transferrable.

(2) Checks for dividends and other payments with respect to stock listed on the Exchange may be presented for immediate payment.

(3) Scrip issued to holders of a security listed on the Exchange and representing a fractional interest in a security listed on the Exchange will, during the period provided for consolidation thereof, be accepted for such purpose.

(4) A security listed on the Exchange which is convertible will be accepted for conversion.

If at any time the transfer office or agency for a security listed on the Exchange shall be located north of Chambers Street, the Corporation will arrange, at its own cost and expense, that its registrar's office, or some other suitable office satisfactory to the Exchange and south of Chambers Street, will receive and redeliver all securities there tendered for the purpose of transfer.

If the transfer books for a security of the Corporation listed on the Exchange should be closed permanently, the Corporation will continue to split up certificates for such security into certificates of smaller denominations in the same name so long as such security continues to be dealt in on the Exchange.

If checks for dividends or other payments with respect to stock listed on the Exchange are drawn on a bank located outside the City of New York, the Corporation will also make arrangements for payment of such checks at a bank, trust company or other agency located in the Borough of Manhattan, City of New York.

c. A registrar where stock of the Corporation listed on the Exchange shall be registerable. Such registrar shall be a bank or trust company not acting as transfer agent for the same security.

2. The Corporation will not appoint a transfer agent, registrar or fiscal agent of, nor a trustee under a mortgage or other instrument relating to, any security of the Corporation listed on the Exchange without prior notice to the Exchange, and the Corporation will not appoint a registrar for its stock listed on the Exchange unless such registrar, at the time of its appointment becoming effective, is qualified with the Exchange as a registrar for securities listed on the Exchange; nor will the Corporation select an officer or director of the Corporation as a trustee under a mortgage or other instrument relating to a security of the Corporation listed on the Exchange.

3. The Corporation will have on hand at all times a sufficient supply of certificates to meet the demands for transfer. If at any time the stock certificates of the Corporation do not recite the preferences of all classes of its stock, it will furnish to its stockholders, upon request and without charge, a printed copy of preferences of all classes of such stock.

4. The Corporation will publish immediately to the holders of any of its securities listed on the Exchange any action taken by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange; and will give prompt notice to the Exchange of any such action; and will afford the holders of its securities listed on the Exchange a proper period within which to record their

interests and to exercise their rights; and will issue all such rights or benefits in form approved by the Exchange and will make the same transferable, exercisable, payable and deliverable in the Borough of Manhattan in the City of New York.

5. The Corporation will solicit proxies for all meetings of stockholders.

6. The Corporation will issue new certificates for securities listed on the Exchange replacing lost ones forthwith upon notification of loss and receipt of proper indemnity. In the event of the issuance of any duplicate bond to replace a bond which has been alleged to be lost, stolen or destroyed and the subsequent appearance of the original bond in the hands of an innocent bondholder, either the original or the duplicate bond will be taken up and cancelled and the Corporation will deliver to such holder another bond theretofore issued and outstanding.

.....

By

Date

Exhibit B

STOCK WATCH FORM

[(BAI) Basic Inc.]

(Name of Company)

KICKOUT

REFERRAL [X]

OTHER

Date [7/14/78]

Time [2:52]

Rep [SSH]

Market Activity [+3¹/₈ to 26⁷/₈ (New High) on 18,200 sh.]
Dow Jones [+10. (illegible)]

Coordinators Comments:

[Floor Official Requested (Delaney)]

COMPANY REPLY

DURING THE COURSE OF OUR CONVERSATION WITH THE COMPANY, WE ARE EXPECTED TO COVER ALL POINTS LISTED BELOW IN ORDER TO ASSIST US IN DETERMINING IF THERE ARE ANY CORPORATE DEVELOPMENTS TO ACCOUNT FOR THE UNUSUAL ACTIVITY ETC. IF A REPLY IS QUALIFIED OR INDEFINITE WE MUST INQUIRE FURTHER.

COMPANY CONTACT (Name/Title)

[Ted Thomas, Treas. & Sect.] TIME OF CONTACT [3:00]

- UNDISCLOSED MERGER OR ACQUISITION PLANS
- NEW PRODUCTS, DISCUSSIONS OR CONTACTS
- TENDER OFFER OR PURCHASE OF OWN SHARES

(Note: material in brackets is handwritten.)

- ANYTHING IN THE AREA OF SALES, EARNINGS, DIVIDENDS ETC.
- TIMING OF NEXT EARNINGS RELEASE
- NEW DEVELOPMENTS RELATING TO PRIOR ANNOUNCEMENTS
- INDUSTRY NEWS
- OVERHANGING BLOCKS OR PENDING SECONDARIES
- RUMORS
- ANALYSTS REPORTS
- ANYTHING ELSE WHICH MIGHT BE CAUSING THE REACTION

REPS COMMENTS:

[No Corporate Developments]

IMPORTANT NOTE: UNLESS THE CONTACT IS THE CHIEF EXECUTIVE OFFICER, WE SHOULD ASK THAT HE BE CONTACTED REGARDING THE INQUIRY. IF HE IS OUT OF TOWN, ATTEMPTS SHOULD BE MADE TO REACH HIM SINCE THIS MAY BE INDICATIVE OF DEVELOPMENTS. ALERT THE CONTACT THAT UNLESS WE ARE INFORMED TO THE CONTRARY HIS/HER RESPONSE WILL BE CONSIDERED THE COMPANY'S & CEO'S OFFICIAL RESPONSE.

SIGNED /s/ [Illegible]

[R.J.—3:02 p.m.]

(Note: material in brackets is handwritten.)

Exhibit C

STOCK WATCH—ON-LINE ALERT REPORT

DATE [9/25/78] TIME [11:07] BY [RHT]

STOCK [Basic Industries] SYMBOL [BAI] POST ____

I. CLASS OF SITUATION:

- ☐ CALL FROM STOCK LIST ☐ BROAD TAPE
☐ OTHER NEWS ☒ MARKET ACTION—KICK-OUT

II. DESCRIPTION OF SITUATION:

[+25 to 33 on 32500]

III. ACTION:

[Reg to Contact—NCD]

IV. INFORMATION ONLY:

TIME ____ OFFICIAL [Prog[illegible]]

IF HALT OR OPEN DELAY

☐ HALT ☐ OPEN DELAY TIME ____
 PRICE ____ OFFICIAL(S) ____
 REOPEN ____

V. FURTHER COMMENTS:

Exhibit D

STOCK WATCH FORM

Basic Inc.

(Name of Company)

KICKOUT ____

REFERRAL ____

OTHER ☒ ____

Date [(illegible)]

Time [11:25]

Rep [DD]

(Note: material in brackets is handwritten.)

- Market Activity [*BAI + 2 1/2 to 32 7/8 or 28,500*]

Dow Jones [*13.23*]

Coordinators Comments:

—*Hit Annual High of 33 3/8 earlier today.*

—*Floor Gov (Crager) request*

—*Last [Illegible] - 8/7 2nd Q 949 [Illegible] .10*

—*Fri up 2 1/8 or 31,900*

—*Request [Illegible]*

COMPANY REPLY

DURING THE COURSE OF OUR CONVERSATION WITH THE COMPANY, WE ARE EXPECTED TO COVER ALL POINTS LISTED BELOW IN ORDER TO ASSIST US IN DETERMINING IF THERE ARE ANY CORPORATE DEVELOPMENTS TO ACCOUNT FOR THE UNUSUAL ACTIVITY ETC. IF A REPLY IS QUALIFIED OR INDEFINITE WE MUST INQUIRE FURTHER.

COMPANY CONTACT (Name/Title)

[*Mathew Ludwwig Sr. VP Fin.*] Time of Contact *11:30*

- UNDISCLOSED MERGER OR ACQUISITION PLANS
- NEW PRODUCTS, DISCUSSION OR CONTACTS
- TENDER OFFER OR PURCHASE OF OWN SHARES
- ANYTHING IN THE AREA OF SALES, EARNINGS, DIVIDENDS ETC.
- TIMING OF NEXT EARNINGS RELEASE
- NEW DEVELOPMENTS RELATING TO PRIOR ANNOUNCEMENTS
- INDUSTRY NEWS
- OVERHANGING BLOCKS OR PENDING SECONDARIES
- RUMORS
- ANALYSTS REPORTS
- ANYTHING ELSE WHICH MIGHT BE CAUSING THE REACTION

(Note: material in brackets is handwritten.)

REPS COMMENTS:

[*Illegible*]

IMPORTANT NOTE: UNLESS THE CONTACT IS THE CHIEF EXECUTIVE OFFICER, WE SHOULD ASK THAT HE BE CONTACTED REGARDING THE INQUIRY. IF HE IS OUT OF TOWN, ATTEMPTS SHOULD BE MADE TO REACH HIM SINCE THIS MAY BE INDICATIVE OF DEVELOPMENTS. ALERT THE CONTACT THAT UNLESS WE ARE INFORMED TO THE CONTRARY HIS/HER RESPONSE WILL BE CONSIDERED THE COMPANY'S & CEO'S OFFICIAL RESPONSE.

SIGNED */s/ [Illegible]*

[*—Carl—*]

Exhibit E

STOCK WATCH—ON-LINE ALERT REPORT

DATE [*12/15/78*] TIME [*12:07*] BY [*RGE*]

STOCK [*Basic Industries*] SYMBOL [*BAI*] POST _____

I. CLASS OF SITUATION:

- ☐ CALL FROM STOCK LIST ☐ BROAD TAPE
☐ OTHER NEWS ☒ MARKET ACTION—KICK-OUT

II. DESCRIPTION OF SITUATION:

[*+ 26 to 30 3/8 on 8300*]

[*Scattered*]

III. ACTION:

[*Reg to Contact—NCD*]

Dave Dolan spoke to Ted Thomas 12.10

2.25 NeD again [Illegible]

(Note: material in brackets is handwritten.)

IV. INFORMATION ONLY:

TIME ____ OFFICIAL [Delaney]

IF HALT OR OPEN DELAY

☐ HALT ☐ OPEN DELAY TIME ____

PRICE ____ OFFICIAL(S) ____

INDICATION(S) ____

REOPEN ____

V. FURTHER COMMENTS:

Exhibit F

STOCK WATCH FORM

Basic Incorporated

(Name of Company)

KICKOUT ____

REFERRAL ____

OTHER X

Date [[Illegible]]

Time [12:10]

Rep [DD]

Market Activity [[Illegible]] Dow Jones [1-2]

Coordinators Comments:

yesterday down

[illegible]

+ 4³/₈ 32¹/₂ 22,300

COMPANY REPLY

DURING THE COURSE OF OUR CONVERSATION WITH THE COMPANY, WE ARE EXPECTED TO COVER ALL POINTS LISTED BELOW IN ORDER TO ASSIST US IN DETERMINING IF THERE ARE ANY CORPORATE DEVELOPMENTS TO ACCOUNT FOR THE UNUSUAL ACTIVITY ETC. IF A REPLY IS QUALIFIED OR INDEFINITE WE MUST INQUIRE FURTHER.

(Note: material in brackets is handwritten.)

COMPANY CONTACT (Name/Title)

[Ted Thomas, Sect. & Treas.] TIME OF CONTACT 12:10/2:2

- UNDISCLOSED MERGER OR ACQUISITION
- NEW PRODUCTS, DISCUSSIONS OR CONTACTS
- TENDER OFFER OR PURCHASE OF OWN SHARES
- ANYTHING IN THE AREA OF SALES, EARNINGS, DIVIDENDS ETC.
- TIMING OF NEXT EARNINGS RELEASE
- NEW DEVELOPMENTS RELATING TO PRIOR ANNOUNCEMENTS
- INDUSTRY NEWS
- OVERHANGING BLOCKS OR PENDING SECONDARIES
- RUMORS
- ANALYSTS REPORTS
- ANYTHING ELSE WHICH MIGHT BE CAUSING THE REACTION

REPS COMMENTS:

[No corporate officials are currently available, all office at a luncheon-related to business or market activity.

Company again knows of no reason for activity. Co had previously had a kickout—at which time a “no corporates” was given.]

IMPORTANT NOTE: UNLESS THE CONTACT IS THE CHIEF EXECUTIVE OFFICER, WE SHOULD ASK THAT HE BE CONTACTED REGARDING THE INQUIRY. IF HE IS OUT OF TOWN, ATTEMPTS SHOULD BE MADE TO REACH HIM SINCE THIS MAY BE INDICATIVE OF DEVELOPMENTS. ALERT THE CONTACT THAT UNLESS WE ARE INFORMED TO THE CONTRARY HIS/HER RESPONSE WILL BE CONSIDERED THE COMPANY'S & CEO'S OFFICIAL RESPONSE.

SIGNED /s/ D. Dolan

(Note: material in brackets is handwritten.)

[PX 6]

SIX WEEKS HIGH LOW REPORT

BAI

09/25/78

DAY	OPEN	HIGH	LOW	LAST	TICK	VOLUME	CHANGE
08/15/78	26 ³ / ₈	26 ⁷ / ₈	26 ³ / ₈	26 ³ / ₄	+	6100	
08/16/78	27	28 ¹ / ₈	27	28 ¹ / ₈	+	6300	+ 1 ³ / ₈
08/17/78	28 ¹ / ₄	28 ³ / ₈	28 ¹ / ₈	28 ¹ / ₈	-	4100	0
08/18/78	28 ¹ / ₄	28 ⁵ / ₈	27 ⁷ / ₈	28 ¹ / ₂	-	3000	+ ³ / ₈
WEEK	26 ³ / ₈	28 ⁵ / ₈	26 ³ / ₄	28 ¹ / ₂	-	19500	
08/21/78	28 ⁵ / ₈	29	27 ¹ / ₂	27 ³ / ₄	+	9100	- ³ / ₄
08/22/78	27 ¹ / ₂	27 ⁵ / ₈	27 ¹ / ₄	27 ¹ / ₂	+	6000	- ¹ / ₄
08/23/78	27 ⁷ / ₈	28 ³ / ₈	27 ⁷ / ₈	28	-	3700	+ ¹ / ₂
08/24/78	28	28 ⁷ / ₈	27 ⁷ / ₈	28 ⁵ / ₈	-	5900	+ ⁵ / ₈
08/25/78	28 ⁷ / ₈	29 ³ / ₈	28 ¹ / ₂	29 ³ / ₈	+	7600	+ ³ / ₄
WEEK	28 ⁵ / ₈	29 ³ / ₈	27 ¹ / ₄	29 ³ / ₈	+	32300	+ ⁷ / ₈
08/28/78	29 ³ / ₄	29 ⁷ / ₈	29 ¹ / ₄	29 ¹ / ₄	-	8000	- ¹ / ₈
08/29/78	29 ¹ / ₂	29 ¹ / ₂	29	29	-	2800	- ¹ / ₄
08/30/78	29	29 ³ / ₈	28 ³ / ₈	28 ³ / ₈	-	4400	- ⁵ / ₈
08/31/78	28	28 ¹ / ₂	27 ³ / ₄	28	+	5700	- ³ / ₈
09/01/78	27 ⁷ / ₈	28 ⁵ / ₈	27 ⁵ / ₈	28 ⁵ / ₈	+	6100	+ ⁵ / ₈
WEEK	29 ³ / ₄	29 ⁷ / ₈	27 ⁵ / ₈	28 ⁵ / ₈	+	27000	- ¹ / ₄

JA 460

DAY	OPEN	HIGH	LOW	LAST	TICK	VOLUME	CHANGE
09/05/78	28 ¹ / ₄	28 ³ / ₄	28	28 ³ / ₄	+	6200	+ ¹ / ₈
09/06/78	28 ³ / ₄	29	28 ³ / ₄	29	+	900	+ ¹ / ₄
09/07/78	28 ³ / ₄	28 ³ / ₄	28 ¹ / ₈	28 ¹ / ₈	-	900	- ⁷ / ₈
09/08/78	28	28 ¹ / ₂	27 ⁷ / ₈	28 ³ / ₈	+	2600	+ ¹ / ₄
WEEK	28 ¹ / ₄	29	27 ⁷ / ₈	28 ³ / ₈	+	10600	- ¹ / ₄
09/11/78	28	28 ¹ / ₄	27 ³ / ₄	27 ³ / ₄	-	2000	- ⁵ / ₈
09/12/78	28	28 ¹ / ₈	27 ⁷ / ₈	28 ¹ / ₈	+	2000	+ ³ / ₈
09/13/78	28 ³ / ₈	28 ³ / ₈	28 ¹ / ₄	28 ¹ / ₄	-	2000	+ ¹ / ₈
09/14/78	28 ¹ / ₂	28 ⁵ / ₈	28 ¹ / ₈	28 ³ / ₈	-	7800	+ ¹ / ₈
09/15/78	28 ¹ / ₈	28 ¹ / ₂	28 ¹ / ₈	28 ¹ / ₄	-	1500	- ¹ / ₈
WEEK	28	28 ⁵ / ₈	27 ³ / ₄	28 ¹ / ₄	-	15300	- ¹ / ₈
09/18/78	28	28	27 ⁷ / ₈	27 ⁷ / ₈	-	1900	- ³ / ₈
09/19/78	28 ¹ / ₈	28 ¹ / ₄	27 ³ / ₈	27 ³ / ₈	-	4000	- ¹ / ₂
09/20/78	27 ¹ / ₄	28 ³ / ₈	27 ¹ / ₈	28	+	4900	+ ⁵ / ₈
09/21/78	28	28 ¹ / ₄	27 ³ / ₄	28 ¹ / ₄	+	2800	+ ¹ / ₄
09/22/78	28 ¹ / ₈	30 ³ / ₈	28 ¹ / ₈	30 ³ / ₈	+	31900	+ 2 ¹ / ₈
WEEK	28	30 ³ / ₈	27 ¹ / ₈	30 ³ / ₈	+	45500	+ 2 ¹ / ₈
09/25/78	31 ¹ / ₂	34 ¹ / ₈	31 ¹ / ₂	33 ³ / ₄	-	58400	+ 3 ³ / ₈

JA 461

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

Case No. C79-1220

Judge William K. Thomas

MAX L. LEVINSON, et al.,

Plaintiffs

—against—

BASIC INCORPORATED, et al.,

Defendants

AFFIDAVIT OF MAX MULLER

Max Muller, being first duly sworn, deposes and says that:

1. I am personally familiar with the facts stated below.
2. I was a director of Basic Incorporated ("Basic") during the period from October 1, 1976 to December 20, 1978.
3. I was President of Basic during the period from October 1, 1976 to December 20, 1978.
4. During 1978, my main purpose in maintaining contacts with James B. Kelly, Vice President in charge of the Industrial Products Group of Combustion Engineering, Inc. ("C-E"), was to explore the feasibility of Basic acquiring the refractories division of C-E.
5. During the period from October 1, 1976 through December 15, 1978, I was not aware of any present or pending corporate developments within Basic which would account for the trading activity or price fluctuations in Basic's stock.

6. At no time during the period October 1, 1976 through December 15, 1978 did I associate any contacts between C-E and Basic representatives with any trading activity or price fluctuations in Basic's stock.

7. I was not aware of any offer by C-E to buy Basic's stock until approximately the middle of December of 1978 at which time I learned that Arthur Santry, President of C-E, would come to Basic on December 19, 1978 to make an offer to purchase Basic stock.

8. I was aware that over the years there had been periodic fluctuations in the price and volume of Basic stock on the New York Stock Exchange.

9. During the period from October 1, 1976 to December 20, 1978, I made no purchases of Basic common or preference stock.

FURTHER AFFIANT SAYETH NOT.

- /s/ MAX MULLER
Max Muller

SWORN TO AND SUBSCRIBED before me this [28th] day of [September], 1982.

/s/ CARMEN E. GARRETT
Notary Public

CARMEN E. GARRETT
Notary Public, State of Ohio-Cuya. Cty.
My Commission Expires Jan. 15, 1987

(Note: material in brackets is handwritten.)

EXHIBIT 1

OCTOBER 1977 STATEMENT

"BASIC INC. STOCK REACHES NEW HIGH IN HEAVY TRADING

Stock of Basic Inc. reaches a new high of 20^{5/8} yesterday on volume of 29,000 shares, closing at 20. It was as low as 15 last month but has been heavily traded lately, including 40,000 shares Oct. 7.

President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland based maker of refractories for the steel industry."

SEPTEMBER 1978 STATEMENT

"Basic, Inc. Can't Explain Stock Activity Cleve-DJ-Basic, Inc. said it isn't aware of any present or pending company development to explain the unusual trading activity in its Common and Preferred stock.

The common is trading at 34 1-4 up 1-2 on 2600 shares. The preferred has not yet opened.

Yesterday Basic common closed at 33 3-4 up 3 3-8 and preferred closed at 72 3-4 up 5 3-4. On Friday the common closed up 2 1-8 and the preferred was up 6.

Basic had first half earnings of \$2.7 million or \$1.81 a share up from \$2.1 million or \$1.45 a share a year earlier. Sales rose to \$40 million from \$35.3 million.

-0- 10 27 AM EDT Sep 26-78" DX 1 [26].

NOVEMBER 1978 STATEMENT

"With respect to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months."

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

Case No. C79-1220

Judge William K. Thomas

MAX L. LEVINSON, et al.,

Plaintiffs

—against—

BASIC INCORPORATED, et al.,

Defendants

AFFIDAVIT OF MATHEW J. LUDWIG

Mathew J. Ludwig, being first duly sworn, deposes and says that:

1. I am personally familiar with the facts stated below.
2. I was a director of Basic Incorporated ("Basic") during the period from October 1, 1976 to December 20, 1978.
3. I was Vice President-Finance of Basic during the period October 1, 1976 to June 1, 1977 and Senior Vice President-Finance and Administration during the period June 1, 1977 to December 20, 1978.
4. I was not aware of any offer by C-E to buy Basic's stock until approximately the middle of December of 1978 at which time I learned that Arthur Santry, President of C-E, would come to Basic on December 19, 1978 to make an offer to purchase Basic stock.

5. At no time during the period October 1, 1976 through December 15, 1978 did I associate contacts between C-E and Basic representatives with trading activity or price fluctuations in Basic's stock.

6. During the period from October 1, 1976 through December 15, 1978, I was not aware of any present or pending corporate developments within Basic which would account for the trading activity or price fluctuations in Basic's stock.

7. I was aware that over the years there had been periodic fluctuations in the price and volume of Basic stock on the New York Stock Exchange.

8. During the period from October 1, 1976 to December 20, 1978, I made no open market purchases of Basic common or preference stock.

9. During the period October 1, 1976 to December 15, 1978, the general attitude of Basic's management toward expressions of interest by third parties in acquiring stock or assets of Basic was that management generally should listen to such expressions while at the same time not encouraging any such interest.

FURTHER AFFIANT SAYETH NOT.

/s/ MATHEW J. LUDWIG
Mathew J. Ludwig

SWORN TO AND SUBSCRIBED before me this [8th] day of [October], 1982.

W. SCOTT BRANTLEY, JR.
Notary Public

W. SCOTT BRANTLEY, JR.
Notary Public, State of Ohio-Cuya. Cty.
My Commission Expires July 15, 1985

(Note: material in brackets is handwritten.)

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

Case No. C79-1220

Judge William K. Thomas

MAX L. LEVINSON, et al.,

Plaintiffs

—against—

BASIC INCORPORATED, et al.,

Defendants

AFFIDAVIT OF H. CHAPMAN ROSE

H. Chapman Rose, being duly sworn, deposes and says that:

1. I am personally familiar with the facts stated below.
2. I was a director of Basic Incorporated ("Basic") during the period from October 1, 1976 to December 20, 1978.
3. I was not an officer or an employee of Basic during the period from October 1, 1976 to December 20, 1978.
4. From the time I first read and became aware of the October 1977 statement, the September 1978 statement and the November 1978 statement, until the present, I had and have no knowledge or information which would lead me to believe that any of such statements was false or misleading.
5. At the time that the three statements were issued, I was aware of no negotiations between Basic and Combustion Engineering, Inc. ("C-E") concerning an acquisition of Basic's stock or assets.

6. I was aware that James B. Kelly ("Kelly"), Vice-President in charge of the Industrial Products Group of C-E, had expressed an interest in Basic over a period of years, but the first time I was aware that C-E was making an offer to buy Basic's stock was approximately the middle of December 1978 at which time I learned that Arthur Santry, President of C-E, would visit Basic's offices on December 19, 1978 to submit an offer to buy the stock of Basic.

7. At no time during the period October 1, 1976 through December 15, 1978 did I associate contacts between C-E and Basic representatives with trading activity or price fluctuations in Basic's stock.

8. During the period October 1, 1976 through December 15, 1978, I was not aware of any present or pending corporate developments within Basic which would account for the trading activity or price fluctuations in Basic's stock.

9. I was aware that over the years there had been periodic fluctuations in the price and volume of Basic stock on the New York Stock Exchange.

10. During the period from October 1, 1976 to December 20, 1978, I made no open market purchases of Basic common or preference stock.

11. During the period October 1, 1976 to December 20, 1978, I at no time was involved in the daily business operations of Basic, except to the extent I was consulted as Basic's counsel, and I had and have no reason to believe that management had not issued accurate statements.

12. During the period October 21, 1977 to December 15, 1978, I had no meetings, discussions or other contacts with any representatives of C-E concerning a possible acquisition of Basic or Basic's stock by C-E.

FURTHER AFFIANT SAYETH NOT.

/s/ H. CHAPMAN ROSE
H. Chapman Rose

SWORN TO AND SUBSCRIBED before me this [27th] day of [September], 1982.

/s/ BETSY J. SIMMERS

Notary Public

My Commission

Expires July 31, 1984

EXHIBIT 1

OCTOBER 1977 STATEMENT

"BASIC INC. STOCK REACHES NEW HIGH IN HEAVY TRADING

Stock of Basic Inc. reaches a new high of 20 5/8 yesterday on volume of 29,000 shares, closing at 20. It was as low as 15 last month but has been heavily traded lately, including 40,000 shares Oct. 7.

President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland based maker of refractories for the steel industry."

SEPTEMBER 1978 STATEMENT

"Basic, Inc. Can't Explain Stock Activity Cleve-DJ-Basic, Inc. said it isn't aware of any present or pending company development to explain the unusual trading activity in its Common and Preferred stock.

The common is trading at 34 1-4 up 1-2 on 2600 shares. The preferred has not yet opened.

(Note: material in brackets is handwritten.)

Yesterday Basic common closed at 33 3-4 up 3 3-8 and preferred closed at 72 3-4 up 5 3-4. On Friday the common closed up 2 1-8 and the preferred was up 6.

Basic had first half earnings of \$2.7 million or \$1.81 a share up from \$2.1 million or \$1.45 a share a year earlier. Sales rose to \$40 million from \$35.3 million.

-0- 10 27 AM EDT Sep 26-78" DX I [26].

NOVEMBER 1978 STATEMENT

"With respect to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months."

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO EASTERN DIVISION

Case No. C79-1220

Judge William K. Thomas

MAX L. LEVINSON, et al.,

Plaintiffs

—against—

BASIC INCORPORATED, et al.,

Defendants

AFFIDAVIT OF JOHN C. WILSON

John C. Wilson, being first duly sworn, deposes and says that:

1. I am personally familiar with the facts stated below.
2. I was a director of Basic Incorporated ("Basic") during the period from October 1, 1976 to December 20, 1978.
3. I was not an officer or an employee of Basic during the period from October 1, 1976 to December 20, 1978.
4. I was not consulted about, did not participate in, or give assistance to, the drafting or preparation of (a) the release relating to the article printed in the *Plain Dealer* on October 21, 1977 (the "October 1977 statement"), or (b) the release transmitted by the Dow Jones New Service on or about September 26, 1978 (the "September 1978 statement"), such statements being attached hereto as Exhibit I.
5. I participated in an Audit Committee meeting on November 1, 1978 which reviewed the regular nine-month report dated November 6, 1978 in which appeared the president's statement (the "November 1978 Statement"), such statement being attached hereto as Exhibit I.
6. From the time I first read and became aware of the October 1977 statement, the September 1978 statement and the November 1978 statement, until the present, I had and have no knowledge or information which would lead me to believe that any of such statements was false or misleading.
7. At the time that the three statements were issued, I was aware of no negotiations between Basic and Combustion Engineering, Inc. ("C-E") concerning an acquisition of Basic's stock or assets.
8. I had a general awareness of C-E's contacts with Basic representatives, but the first time I was aware that C-E was

making an offer to buy Basic's stock was on December 19, 1978 at which time I learned that C-E was making an offer on that date to purchase Basic stock.

9. At no time during the period October 1, 1976 through December 15, 1978 did I associate contacts between C-E and Basic representatives with trading activity or price fluctuations in Basic's stock.

10. During the period October 1, 1976 through December 15, 1978, I was not aware of any present or pending corporate developments within Basic which would account for the trading activity or price fluctuations in Basic's stock.

11. I was aware that over the years there had been periodic fluctuations in the price and volume of Basic stock on the New York Stock Exchange.

12. During the period from October 1, 1976 to December 20, 1978, I made no open market purchases of Basic common or preference stock. I sold 944 shares of Basic's common stock on April 4, 1978 in an open market transaction at a price of \$20.00 per share.

13. During the period October 1, 1976 to December 20, 1978, I at no time was involved in the daily business operations of Basic, and I relied on company management with respect to such matters, and I had and have no reason to believe that management would not have issued accurate statements.

14. I had no meetings, discussions or other contacts with any representatives of C-E concerning a possible acquisition of Basic or Basic's stock by C-E.

FURTHER AFFIANT SAYETH NOT.

/s/ JOHN C. WILSON
John C. Wilson

SWORN TO AND SUBSCRIBED before me this [23rd] day of [September], 1982.

/s/ BERNARDINE C. SCHOLL
Notary Public

My Commission Expires
February 19 1984

EXHIBIT 1

OCTOBER 1977 STATEMENT

"BASIC INC. STOCK REACHES NEW HIGH IN HEAVY TRADING

Stock of Basic Inc. reaches a new high of 20 5/8 yesterday on volume of 29,000 shares, closing at 20. It was as low as 15 last month but has been heavily traded lately, including 40,000 shares Oct. 7.

President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland based maker of refractories for the steel industry."

SEPTEMBER 1978 STATEMENT

"Basic, Inc. Can't Explain Stock Activity Cleve-DJ- Basic, Inc. said it isn't aware of any present or pending company development to explain the unusual trading activity in its Common and Preferred stock.

The common is trading at 34 1-4 up 1-2 on 2600 shares. The preferred has not yet opened.

Yesterday Basic common closed at 33 3-4 up 3 3-8 and preferred closed at 72 3-4 up 5 3-4. On Friday the common closed up 2 1-8 and the preferred was up 6.

(Note: material in brackets is handwritten.)

JA 474

Basic had first half earnings of \$2.7 million or \$1.81 a share up from \$2.1 million or \$1.45 a share a year earlier. Sales rose to \$40 million from \$35.3 million.

-0- 10 27 AM EDT Sep 26-78" DX 1 [26].

NOVEMBER 1978 STATEMENT

"With respect to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months."

[PX249]

[Transcription of handwritten diary]

FRIDAY, JULY 30

Mail

Dave Waible re Gabbs

Six months data

TT re Rolfite, products lia

MM, AMC, JDK, AB
re Rolfite - Amer. Elec. Power-Kukin

Aumiller & Connell (EPA part TAT)
re FVQ audit a/c Kirby also sale of stock or assets)
WCC data

Jean Meyer - Troopers

MM re AEP-MSH, Elgin - Hekimian, Loscoscos
Shelter, BI Combustion

Cleanup

JA 475

WEDNESDAY, AUGUST 4

EPA, FVQ Conv. Debentures also TAT

Mail

ERB re revised Krohn terms (tel)

Farkas (tel) re Hekimian

Tel: Dick Meyer - investments

Busta re Bricker - S&L

Davis Date

JSA, Bricmont

Gates luncheon

AMC re DeMuths

TT re: P/S valuation as of 6/30

Capital gains vs 10 year forward averaging

TT re C-E vs BI

MM " "

TUESDAY, DECEMBER 28

Budget

MM and AMC re
CE Canada - license, etc.

SIRMA

AMC & AMC luncheon
re Steetly et al

AMC, JDK & AMC
re Blaw-Knox

Tel: Erb, Leavitt (long) re Trustee - P/S

ABC dissolution: Paddock (tel -2) Jack Sterling
TAT & TT separately

EPA re 12 mos 1976 & adjustments

JA 476

WEDNESDAY, JANUARY 12

Mail

Jim Kelly & MM re CE

Krohn (2) Erb (2)

EPA - re 1977 budget

Mayer

EPA re 1977 budget with
particular ref. to allocation
of PCP between Ref & Chem

HCL re W. Va.

WEDNESDAY, FEBRUARY 2

To & at clinic

Fitch

Treasurer's Club

Bill Fine

C-E agreements - review

AMC re above and fuel

Fitch

Fitch calculations

AMC - TT re CE contract

JA 477

FRIDAY, JUNE 24

Office to Canton. W/HCL to meet
w/Appalachian Exploration Co.

Meeting w/ AEC thru lunch

Canton to office

MM, AMC & Jim Kelly

Aftermath of above w/ MM & AMC

AMC re oil

Mail

THURSDAY, JUNE 30

To Burke

MM, AMC & HCR re CE and Conway
80¢ park & Tel.

To office

TAT re self help gas &
Nelson matters: Tel: JE (2)
CAV (2)

Stock transfer - C Meckes
during luncheon at (CAC)

AMC (JCS part) re major medical

Don Johnson (tel) re development

Mail

MM re acquisition

Cleanup

JA 478

MONDAY, JULY 18

Week end mail

EPA re Elgin

Tel: ESW re MacIntosh

RJL re Covington-Champion

JE re closing agenda

Dorf

ETK, GWC, SH, Corna

Luncheon (UC) Fred Heinz, JSA, RTM

Dictation

RWG - visit

TT re Smith Wesson - Basic Ballistics

MM re C-E; Reed DY

Mail

WEDNESDAY, OCTOBER 12

MM, AMC - Jim Kelly

Mail

Duke Waddell, Jim West, Bob Ratatsky
(Flintkote)

MM, AMC & RWG re Fredonia lime

TT re above

EPA " "

Reed incl. review w/TAT

Mail

JA 479

WEDNESDAY, NOVEMBER 30

Mail

Tel: Huth, Mayer, Roth, Feil, Buford, RP, Mader

AMC re CE & raiders

MM -

Brant - CNB

Tel: RP & CW, Kerester

MM & GMC re Wendling

MM - White Knight

Swope

Detail of B/S Items

FRIDAY, FEBRUARY 24

Mail &

Prep for i

Audit Comm. Mtg.

JAG, HCR, EPA

G.A., CN & CF

Above for lunch

EPA & MM & GWC re Audit
Committee changes

MM & AMC re C-E

Prep for week end mail

Tel: GWE

Mail

JA 480

MONDAY, FEBRUARY 27

To Burke Visited w/ Joe Burke
Waiting for Jim Kelly (Tyler)
MM & JK re Refractories Division
MM & AMC re above
Revise GWE
EPA re projected exercise of options
Reed
Re revised typed GWE memo
TT & Mail
Periodicals
Reed & Other Mail

WEDNESDAY, MARCH 1

HWS re Pentol
Review Brown Print
Mail
ETK luncheon mtg
EPA re 1978 & Budget (JK tel re 5 yrs)
TT re proxy materials revision
Bob Wright re Shaker dues
MM re above & Kelly call
Legal fees and cleanup, old mail
and files

JA 481

THURSDAY, MARCH 2

Mail
AMC re P/S - pensions
Also TT (part) re Benefacts
Publication
EPA - organization
MIC formula
MM re Top Mgmt Night, Elgin gifts
TT organization, C-E
AMC, TT & EPA re profit data for CE
Review Dolomit - Werke contract file

THURSDAY, MARCH 9

Ramada to Airport (Naples)	}	W/MM
Naples to Tampa		
Breakfast & check-in		
Tampa to Hopkins		
Tel at Hopkins		
Hopkins to office		
Office		
JE (luncheon CAC) re Reed,		
EPA re Reed, & Data for JK		
TT re Reed, Nelson & Oil		
HCL re Elgin prospect		
Mail		
Expenses & Mail		

JA 482

WEDNESDAY, MARCH 22

Preston Insley (C-E)

W/ TT & EPA (MM about 15-20 minutes)

All day ex:

tel. conf. w/ JE re condo

THURSDAY, MARCH 23

Mail

Revised dictation

Tel: JJE - re Condo & Nelson, HLS re project
C Acetelli re value of T-H, Bill Beckembach
(2) re WCC, John Childs

?

EPA luncheon mtg. re C-E/Reed (CAC)

John Childs (tel) re forecasts for analysts

AMC re CE

Collins re Kern & Ward

Mills - out of Condo

Nelson (tel) banks said no

JE re above

5WSJs, other accum. mail

JA 483

SUNDAY, MARCH 26

C-E studies

MONDAY, MARCH 27

C-E studies expansion

Jerome & TT re 12/31/77 P/S evaluation

Lunch - Jerome

JE re Nelson latest

CE analysis: MM, AMC, TT & EPA

Cleanup

Mail

WEDNESDAY, MARCH 29

Prep for Dietrich

MM re above & CE

Prep for and talk w/Dietrich

Review w/ TT & EPA: Reed, Valcom CE
and Valcom: during
and after lunch 13.38

Prep for Nelson call (not there)

Prep for Valcom

MM - prep for Valcom

JA 484

MM, ESW, QB review w/
John Mason - Valcom

Dinner & more of above

THURSDAY, MARCH 30

AMC re C-E and options

Mail

RWG re Utah matters

EPA - TT re cash

Prep for Nelson call

Lunch

JJE

Angus McDonald & MM re M&A

TT re CE vs. BI

MM re above

Accum mail, expense a/c

Nelson (tel) re latest

Cleanup

Gee Wake

3 WSJs

JA 485

MONDAY, APRIL 3

JDK re Hold Harmless

Week end mail

MM, AMC, TT & EPA re C-E

Lunch above & CAG

Review and Revise tax returns

Agreements: Rolfite & Hold Harmless

Troopers: Dick Stanner, Kerwin Elmer

EJG, PC, RS, Bill Killgalen, Col.

Adam Reece, Col. Chester Haytt

Mail

THURSDAY, JUNE 1

Mail

Kerester tel re LaGrange IRA

GWE & TT re GWE retirement

Lunch GWE, RWG, AMC & CAG

GWE & TT re retirement

MM - re CE

JDK, JCF part re retention

JA 486

MONDAY, JUNE 5

Mail

TT & EPA
MM, EPA, TT & AMC } re CE
Above ex MM

Lunch AMC, TT & EPA 18.85
re M&A

AMC - Clinic
Exp. a/c

MM, AMC, TT & EPA
re CE

Mail

CE studies & partial review
of 1977 BI Federal Return

TUESDAY, JUNE 6

BJ (tel) re CE from home
Prep for
BJ, MM, AMC, TT & EPA re CE visit
above ex MM
tel - re Larry Manning & AMC re FGT
Torter (tel) re Nat'l Gypsum

HCL and JDK lunch - review patent
on communicator

TT re CE - Votec

w/AMC
Jeff Parker (tel) - nothing special

Dictation

JA 487

EPA re CE studies

Departed early to pick up gear

Diary

Prep for CE mtg.

WEDNESDAY, JUNE 7

JK, MM & AMC re
combination of refractories operations

Tel

UCB Pepper Pike outing

Larry—
Fran Theis
Al Chandler

WEDNESDAY, JUNE 14

EJG (tel) re State Troopers Outing

Peril Electronics; Quick review of annual report
and mtg w/ Bonda, Miller & MM

MM re C-E respective views

Revise dictation

MM luncheon mtg (LG & E Indemnification contract)
(CAC) 10.43

Tel conference re amendment of P/s Plan (Toepfer
(Kerester
(TT

JA 488

EPA re May profit and CE
TT re C.E.
Revise dictation
TAT re tax meeting and sign return
Dictation
JDK re Rolfite - Toxicity & LGE agreement
Diary
Periodicals & GWE retirement

THURSDAY, JUNE 15

Prep for 4 &
Mail
TT & EPA re C-E
(Through luncheon) 15.03
MM & AMC - rehearsal
AMC re USG
Radel (tel) and pack
Prep for 6/16 mtg

FRIDAY, JUNE 16

Tel & Mail
MM & AMC - Review
HCR, MM & AMC re CE
Jamboree
Metro & Hughes

JA 489

TUESDAY, JUNE 20

Mail
AMC re USG & CE -
TT re Edwards
Long tel re GWE
Dictation
Lunch HCL & JDK
MM re MSP
Secrecy agreement
Cleanup JCF
Early departure
2 oz. castor oil, pack & otherwise prep
for clinic. Up half the night a/c co

THURSDAY, JULY 6

To Clinic
Wacksman
Lavik Radiologist
Cardiac
Lunch & review w/ EPA & TT
Tel: Torter (2)
ESW (long re Valcom, fringes and health)
JJE re project
TT - various
AMC re CE & acq. candidates
Mail
Mail

JA 490

MONDAY, JULY 10

Tel: JE re Nelson
Orin re membership
AMC re financials
Otherwise on project
MM & AMC re CE, etc.
AMC re M&A prospects
Project
To & at City Hall
Schneider w/ CEL

FRIDAY, AUGUST 11

Tel: JM
Mail
MM, AMC & TT re Benefacts
JWB re finance & entertainment
EPA re: Elgin mtg. w/ JF
audit committee & addtnl staff
Magnetic Components: ESW tel (also Q report
memos
Prep for Nelson call: Out so advised JE
MM re CE
WCC matters

JA 491

TUESDAY, AUGUST 22

Mail & Tel HLS JE
Internal audit - EPA, also
call to ETK
Pokorny BC/B/S
MM (CAC) Agenda CE 10.24
Nagz, C. - re Warrant Actg.
Barber
JE
Pr

MONDAY, NOVEMBER 27

Prep for
AMC - various
JK, MM & AMC
incl. lunch
MM re Siegal
Periodicals

JA 492

TUESDAY, DECEMBER 12

Mail

Tel: RJL (3) Hitchcock,

TT re CE update

Dictation

Lunch RJL

EPA re 7% retro to 10/1 & 400M reserve

Redo dictation

Tel: Pick (2) Broerman (2)

JSA tel re latest rumors (W.C.C.)

Mail

Prep for meetings w/ BMJ, P.H. & JWB

WEDNESDAY, DECEMBER 13

EPA re

TAT re Taxes

Mail

To & at Cleveland
for Mtgs w/ JWB

C. Meckes

E. Tabol

Paul Huth re Warrant & stock options

BMJ re CE

Office cleanup

3 WSJs & Review CE vs BI

JA 493

THURSDAY, DECEMBER 14

MM re CE

Exercise 1,000 shs & letters, etc.

TT & EPA re CE

MM & AMC re CE and W&Prices
during lunch

EPA & AMC re W&P

AMC & MM prep for J
Siegal, MM & AMC

FRIDAY, DECEMBER 15

Tel Siegal (2) - Cleveland Bond Court

MM & AMC

E&E luncheon

Seigal, (major part) MM, AMC

Post mtg.

Bowling

SUNDAY, DECEMBER 17

Tel: EPA)

TT) Re Questions of Kelly
MM)

DG & JK (tel) re Stop trading

JA 494

MONDAY, DECEMBER 18

. GC, DY

review questions

questions on opern

TUESDAY, DECEMBER 19

Approval

____ and Gunning present during part of mtg.

[PX 93]

1977

Thursday, June 30

—[illegible]

MM; AMC & HCR re CE

[PX 88]

[MM MEMO COVER FOR 1978]

FEBRUARY 1978

Monday 27

10:50 MJL & MM met Jim Kelly of CE Lunch [illegible]

JA 495

JUNE 1978

Wednesday 7 OFFICE 9:00 Jim KELLY OF CE offered \$28.00
[illegible].

JUNE 1978

Friday 18

MJL ATL MM & HCR re CE etc.
HCR AMC MM Union Club.

NOVEMBER 1978

Monday 27

10:00 To Bus to pick up

Kelly from CE

[illegible] MJL-ATC-JIM KELLY-MM

DECEMBER 1978

Thursday 14

OO UCB Exec Comm

[illegible] MJL ATC MM & CE—

Siegel from Kidder-Peabody

JA 496

DECEMBER 1978

Sunday 17

Monday 18

7:30 Am Meeting re CE STOP trading BAI stock. Kelly
[illegible] Xmas Lunch (85) at CAC. Kelly returns [illegible]
3:00 at office

Tuesday 19

[illegible] Sandy & Kelly of CE
[illegible] Kelly, MSL AMC MM
[illegible]

Wednesday 20

[PX 94]

1977

OCTOBER
12 KELLY CE
9:00 AM

1977

[PX 90C]

Addition to LIFO Reserve

Year	Total	BI	Total	C-E
		Per Share† (After Taxes)*		Per Share† (After Taxes)*
1974	\$1,369,900	\$0.80	\$11,927,000	\$0.37
1975	1,041,800	0.70	10,827,000	0.36
1976	1,071,700	0.65	6,238,000	0.20
1977	775,600	0.45	5,000,000	0.18

* As reported for 1974, but assuming in other years that additional income would not change tax not applicable before restriction of LIFO reserve. Note—This is probably not a valid assumption especially with respect to Basic.

† Based on shares used in [illegible]

JA 497

	@50%	@50%
1974	\$0.53	\$0.37
1975	0.40	0.34
1976	0.41	0.19
1977	0.28	0.15

Net Income Per Share

	As Reported		A		B	
	BI	CE	BI	CE	BI	CE
1974	\$2.54	\$2.33	\$3.64	\$2.70	\$3.37	\$2.70
1975	1.80	2.77	2.50	3.13	2.20	3.11
1976	3.21	3.36	3.96	3.56	3.72	3.55
1977	2.82	4.17	3.27	4.35	3.10	4.35

[PX 90]

	CE	BI
Inventories 12/31/77 (net)	435,940,000	14,515,207
LIFO Reserve	34,892,000	4,259,000
Gross	470,832,000	18,774,207
% LIFO on Gross	74%	22.7

BI & CE LIFO % (74%)
equal to 32.6% of BI actual provision

Which is to say BI earnings reflects
excess changes — Pre-Tax 2,870,000
— After-Tax @ 1977 Rate (19.6%) 2,307,000

Per share on any 1,400,000 shares this—
above excess is equal to

	For 4 years	Avg P/Y
Pre-Tax	2.05	0.51
After-Tax	1.65	0.41

VETCO — CE

Market	High	Low
1975	39 ¹ / ₂	21 ¹ / ₂
1976	31	16 ¹ / ₂
1977	24 ³ / ₄	12 ⁷ / ₈

Earnings Per Share (Fiscal 2/31)

1975	2.54
1976	3.69
1977	0.84

(4/1 - 7/1/77 — .08 vs. .24 prior year)

Tender offer — \$23

	NG	US	Price Range		
1973	1.93	2.90	1960-76	\$36-8	\$38-12
	1.69	1.70	1977	18-15	26-25
	1.36	1.65	1978	17-14	24-21
	1.68	2.04			
	2.25	3.41			

1st Q 1978

1978	.57/16	16.23/22
------	--------	----------

		16,000,000
159,700 Paid	6,900,000 [Illegible]	159,700,000
96,000	1,389,000	15,700,000
101,000	[Illegible]	175,000,000

[PX 101]

BASIC AND COMBUSTION ENGINEERING

BASIC	Income				
	(Est.)				
	1978	1977	1976	1975	1974
Steel Production.....	138	124.7	128	116.6	145.7
Amounts (000's)					
Net Sales		\$66,746	\$65,948	\$53,503	\$67,860
Net Income for Common....		3,894	4,372	2,332	3,532
Net Cash Income for					
Common		6,689	6,940	4,518	5,875
Pre tax Income					
Per Share					
Net Income	5.00	2.82	3.31	1.80	2.73
Net Cash Income	7.10	4.91	5.25	3.49	4.54
% Increase	82	(15)	(84)	(34)	

COMBUSTION ENGINEERING		(Est.)	1977	1976	1975	1974
Amounts (000's)		1978				
Net Sales			\$2,044,764	\$1,830,925	\$1,711,151	\$1,428,027
Net Income for Common			66,579	53,196	43,539	36,371
Net Cash Income for						
Common			106,209	85,193	72,248	63,133
Pre tax Income						
Per Share	1974-1978					
Net Income		5.00	4.17	3.36	2.77	2.50
Net Cash Income		7.50	6.63	5.41	4.61	4.23
% Increase	100	20	24	.21	.11	

Note: Basic's income adjusted to eliminate Ceramics' net loss of \$265(000) in 1974.

BASIC AND COMBUSTION ENGINEERING

Relative Values

Net Income	BASIC	CE	BASIC + CE	MARKET VALUE CE @ \$34.75
1978	\$ 5.00	\$ 5.00	1.00	\$ 34.74
1977	2.82	4.17	.68	23.63
2-Year Average	3.91	4.58	.85	29.54
1976	3.31	3.36	.99	34.40
3-Year Average	3.71	4.18	.89	30.93
1975	1.80	2.77	.65	22.59
4-Year Average	3.23	3.82	.85	29.54
1974	2.73	2.50	1.09	37.88
5-Year Average	3.13	3.56	.88	30.58

	BASIC	CE	BASIC + CE	MARKET VALUE CE @ \$34.75
Net Cash Income				
1978	\$ 7.10	\$ 7.50	.95	\$ 33.01
1977	4.91	6.63	.74	25.72
2-Year Average	6.00	7.06	.85	29.54
1976	5.25	5.41	.97	33.71
3-Year Average	5.75	6.51	.88	30.58
1975	3.49	4.61	.76	25.41
4-Year Average	5.19	6.04	.86	29.89
1974	4.54	4.23	1.07	37.18
5-Year Average	5.06	5.68	.89	30.93
Dividend - Current	\$ 1.40	\$ 2.00	.70	\$24.33
Book Value (9/30/78)	\$22.74	\$29.13	[Illegible]	\$27.11 31.62
Market Price for 1978				
High	\$35.00	\$44.875	.78	\$27.11
Low	19.00	31.000	.61	21.20
Average	\$27.00	\$37.94	.71	\$24.67
Current at 12/11/78	\$29.125	\$34.75	.84	\$ 29.19

BASIC AND COMBUSTION ENGINEERING

	Income			
BASIC	(Est.) 1978	1977	1976	1975
Steel Production	138	124.7	128	116.6
Amounts (000's)				
Net Sales		\$66,746	\$65,948	\$53,503
Net Income for Common		3,894	4,372	2,332
Net Cash Income for Common		6,689	6,940	4,518
Pre tax Income				5,875
Per Share	1974-1978			
Net Income	5.00	2.82	3.31	1.80
Net Cash Income	7.10	4.91	5.25	3.49
% Increase	82	(15)	(84)	(34)
				2.73
				4.54

COMBUSTION ENGINEERING		(Est.)	1977	1976	1975	1974
Amounts (000's)		1978				
Net Sales						
Net Income for Common			\$2,044,764	\$1,830,925	\$1,711,151	\$1,428,027
Net Cash Income for			66,579	53,196	43,539	36,371
Common						
Pre tax Income			106,209	85,193	72,248	63,133
Per Share	1974-1978					
Net Income		5.00	4.17	3.36	2.77	2.50
Net Cash Income		7.50	6.63	5.41	4.61	4.23
% Increase	100	20	24	21	11	

Note: Basic's income adjusted to eliminate Ceramics' net loss of \$265(000) in 1974.

IPX 1021
BASIC AND COMBUSTION ENGINEERING
Balance Sheet
September 30, 1978

(000's)	BASIC		CE	
	AMOUNT	PERCENT	AMOUNT	PERCENT
NET ASSETS				
Net Current Assets				
Current Assets				
Cash and Equivalent..	\$ 1,985		\$ 384,067	
Accounts Receivable..	14,588		335,010	
Inventories	12,870		455,450	
Prepaid Items, etc. ...	542		13,681	
Total	29,985		1,188,208	
Current Liabilities	9,530		1,081,781	
Net Current Assets ..	20,455	45.9	106,427	15.5
Net Fixed Assets				
Cost	69,394		763,988	
Less Depreciation	46,077		324,879	
Net Fixed Assets	23,317	52.4	439,109	64.1
Other Assets	755	1.7	139,011(a)	20.4
Net Assets	\$ 44,527	100.0	\$ 684,547	100.0

CAPITALIZATION	BASIC		CE	
	AMOUNT	PERCENT	AMOUNT	PERCENT
Long-Term Debt	\$ 9,187	20.6	\$ 141,310	20.6
Reserves (Income Tax)	-0-		70,037	10.3
Minority Interests	-0-		1,269	0.2
Shareholders' Equity				
Preferred Shares	2,818	6.3	—	—
Common Shares	<u>32,522</u>	<u>73.1</u>	<u>471,931</u>	<u>68.9</u>
Total Shareholders' Equity	35,340	79.4	471,931	68.9
Total Capitalization ..	<u>\$ 44,527</u>	<u>100.0</u>	<u>\$ 684,547</u>	<u>100.0</u>
Common Shares Outstanding	1,430,443		16,200,000(?)	

(a) Includes \$67,873(000) good will at 12/31/77 [illegible]

BASIC AND COMBUSTION ENGINEERING

BASIC	Income			
	(Est.) 1978	1977	1976	1975
Steel Production	138	124.7	128	116.6
Amounts (000's)				
Net Sales		\$66,746	\$65,948	\$53,503
Net Income for Common		3,894	4,372	2,332
Net Cash Income for Common		6,689	6,940	4,518
Pre tax Income				5,875
Per Share	1974-1978			
Net Income	5.00	2.82	3.31	1.80
Net Cash Income	7.10	4.91	5.25	3.49
% Increase	82	77	(84)	(34)

1974
145.7

\$67,860
3,532

5,875

2.73
4.54

COMBUSTION ENGINEERING	(Est.)			
	1978	1977	1976	1975
Amounts (000's)				
Net Sales		\$2,044,764	\$1,830,925	\$1,711,151
Net Income for Common		66,579	53,196	43,539
Net Cash Income for Common		106,209	85,193	72,248
Pre tax Income				
Per Share	1974-1978			
Net Income	5.00	4.17	3.36	2.77
Net Cash Income	7.50	6.63	5.41	4.61
% Increase	100	24	.21	.11

Note: Basic's income adjusted to eliminate Ceramics' net loss of \$265(000) in 1974.

BASIC AND COMBUSTION ENGINEERING

	Relative Values			MARKET VALUE CE @ \$34.75
	BASIC	CE	BASIC + CE	
Net Income				
1978	\$ 5.00	\$ 5.00	1.00	\$ 34.74
1977	2.82	4.17	.68	23.63
2-Year Average	3.91	4.58	.85	29.54
1976	3.31	3.36	.99	34.40
3-Year Average	3.71	4.18	.89	30.93
1975	1.80	2.77	.65	22.59
4-Year Average	3.23	3.82	.85	29.54
1974	2.73	2.50	1.09	37.88
5-Year Average	3.13	3.56	.88	30.58

	BASIC	CE	BASIC ÷ CE	MARKET VALUE CE @ \$34.75
Net Cash Income				
1978	\$ 7.10	\$ 7.50	.95	\$ 33.01
1977	4.91	6.63	.74	25.72
2-Year Average	6.00	7.06	.85	29.54
1976	5.25	5.41	.97	33.71
3-Year Average	5.75	6.51	.88	30.58
1975	3.49	4.61	.76	25.41
4-Year Average	5.19	6.04	.86	29.89
1974	4.54	4.23	1.07	37.18
5-Year Average	5.06	5.68	.89	30.93
Dividend - Current	\$ 1.40	\$ 2.00	.70	\$24.33
Book Value (9/30/78)	\$22.74	\$29.13	[Illegible]	\$27.11 31.62
Market Price for 1978				
High	\$35.00	\$44.875	.78	\$27.11
Low	19.00	31.000	.61	21.20
Average	\$27.00	\$37.94	.71	\$24.67
Current at 12/11/78	\$29.125	\$34.75	.84	\$ 29.19

11'X 981

BASIC AND COMBUSTION ENGINEERING

	Relative Values		BASIC ÷ CE	MARKET VALUE CE @ \$44.25
	BASIC	CE		
Net Income				
1975	\$ 1.80	\$ 4.16	.43	\$19.03
1974	2.73	3.50	.78	34.52
2-year Average	2.27	3.83	.59	26.11
1973	2.46	4.05	.61	26.99
3-year Average	\$ 2.33	\$ 3.90	.60	\$26.55
Net Cash Income				
1975	\$ 3.49	\$ 7.09	.49	\$21.68
1974	4.54	6.19	.73	32.30
2-year Average	4.02	6.64	.61	26.99
1973	4.59	6.39	.72	31.86
3-year Average	\$ 4.21	\$ 6.56	.64	\$28.32
Dividend - current	\$.80	\$ 2.00	.40	\$17.70
Book Value (12/31/75)	\$17.09	\$35.40	.48	\$21.24
Market Price for 1976				
High	\$16.25	\$48.13	.38	\$16.82
Low	7.63	32.75	.23	10.18
Average	\$11.95	\$40.44	.29	\$12.83
Current at 8/2/76	\$14.88	\$44.25	.34	\$15.05

BASIC AND COMBUSTION ENGINEERING

JA 512

BASIC	Income		
	1975	1974	1973
Amounts (000's)			
Net Sales.....	\$ 53,503	\$ 67,860	\$ 58,512
Net Income for Common	2,332	3,532	3,178
Net Cash Income for Common.....	4,518	5,875	5,945
Per Share			
Net Income.....	1.80	2.73	2.46
Net Cash Income	3.49	4.54	4.59

COMBUSTION ENGINEERING

Amounts (000's)			
Net Sales.....	1,711,151	\$1,428,027	\$1,168,578
Net Income for Common	43,539	36,371	41,805
Net Cash Income for Common.....	72,248	63,133	64,786
Per Share			
Net Income.....	4.16	3.50	4.05
Net Cash Income	7.09	6.19	6.39

Note: Basic's income adjusted to eliminate ceramics net losses of \$265(000) in 1974 and \$750(000) in 1973.

JA 513

BASIC AND COMBUSTION ENGINEERING

Balance Sheet

December 31, 1975

(000's)	BASIC		CE	
	AMOUNT	PERCENT	AMOUNT	PERCENT
NET ASSETS				
Net Current Assets				
Current Assets				
Cash and Equivalent..	\$ 1,525		\$ 51,559	
Accounts Receivable..	7,861		284,347	
Inventories	15,240		375,007	
Prepaid Items, etc. ...	406		6,116	
Total	25,032		717,029	
Current Liabilities	7,549		551,294	
Net Current Assets ..	17,483	42.6	165,735	32.9
Net Fixed Assets.				
Cost	62,208		526,315	
Less Depreciation	39,696		226,038	
Net Fixed Assets	22,512	54.8	300,277	59.7
Other Assets	1,081	2.6	37,180	7.4
Net Assets	\$ 41,076	100.0	\$ 503,192	100.0

CAPITALIZATION	BASIC		CE	
	AMOUNT	PERCENT	AMOUNT	PERCENT
Long-Term Debt	\$14,208	34.6	\$ 98,254	19.5
Reserves (Income Tax)	-0-		38,733	7.7
Minority Interests	-0-		1,272	.3
Shareholders' Equity				
Preferred Shares	4,748	11.6	4,103	.8
Common Shares	22,120	53.8	360,830	71.7
Total Shareholders' Equity	26,868	65.4	364,934	72.5
Total Capitalization ..	\$ 41,076	100.0	\$ 503,192	100.0
Common Shares Outstanding	1,294,450		10,192,676	

1978-1991

BASIC AND COMBUSTION ENGINEERING

Income	1976	1975	1974

BASIC

Amounts (000's)			
Net Sales.....	\$ 65,948	\$ 53,503	\$ 67,860
Net Income for Common	4,372	2,332	3,532
Net Cash Income for Common.....	6,940	4,518	5,875
Per Share			
Net Income.....	3.31	11.80	2.73
Net Cash Income	5.25	3.49	4.54

COMBUSTION ENGINEERING

Amounts (000's)			
Net Sales.....	\$1,830,925	\$1,711,151	\$1,428,027
Net Income for Common	53,196	43,539	36,371
Net Cash Income for Common.....	85,193	72,248	63,133
Per Share			
Net Income.....	5.04	4.16	3.50
Net Cash Income	8.02	7.09	6.19

Note: Basic's income adjusted to eliminate ceramics net losses of \$265(000) in 1974.

BASIC AND COMBUSTION ENGINEERING

Balance Sheet

December 31, 1976

(000's) NET ASSETS	BASIC		CE	
	AMOUNT	PERCENT	AMOUNT	PERCENT
Net Current Assets				
Current Assets				
Cash and Equivalent	\$ 2,739		\$184,889	
Accounts Receivable	9,224		297,023	
Inventories	13,520		371,755	
Prepaid Items, etc.	361		21,504	
Total	25,864		875,171	
Current Liabilities	6,375		721,292	
Net Current Assets	19,489	45.9	153,879	27.8
Net Fixed Assets				
Cost	63,592		590,371	
Less Depreciation	41,356		246,990	
Net Fixed Assets	22,236	52.3	343,381	62.1
Other Assets	780	1.8	56,028	10.1
Net Assets	\$42,505	100.0	\$553,288	100.0

JA 516

CAPITALIZATION	BASIC		CE	
	AMOUNT	PERCENT	AMOUNT	PERCENT
Long-Term Debt	\$12,075	28.4	\$108,753	19.6
Reserves (Income Tax)	-0-		44,732	8.1
Minority Interests	-0-		1,386	.3
Shareholders' Equity				
Preferred Shares	4,748	11.2	3,674	.7
Common Shares	25,682	60.4	394,743	71.3
Total Shareholders' Equity ..	30,430	71.6	398,417	72.0
Total Capitalization	\$42,505	100.0	\$553,288	100.0
Common Shares Outstanding ..	1,313,150		10,418,726	

JA 517

BASIC AND COMBUSTION ENGINEERING

Relative Values

	BASIC	CE	BASIC - CE	MARKET VALUE CE @ \$62.13
Net Income				
1976	\$ 3.31	\$ 5.04	.66	\$41.00
1975	1.80	4.16	.43	26.72
2-Year Average	2.56	4.60	.56	\$34.79
1974	2.73	3.50	.78	48.46
3-Year Average	\$ 2.61	\$ 4.23	.62	\$38.52
Net Cash Income				
1976	\$ 5.25	\$ 8.02	.65	\$40.38
1975	3.49	7.09	.49	30.44
2-Year Average	4.37	7.56	.58	36.03
1974	4.54	6.19	.73	43.35
3-Year Average	\$ 4.43	\$ 7.10	.62	\$38.52
Dividend - current	\$ 1.00	\$ 2.00	.50	\$31.06
Book Value (12/31/76)	\$19.44	\$36.47	.53	\$32.93
Market Price for 1977				
High	\$19.63	\$63.50	.31	\$19.26
Low	14.38	45.63	.32	19.88
Average	\$17.00	\$54.57	.31	\$19.26
Current at 6/30/77	\$16.88	\$62.13	.27	\$16.88

JA 518

[PX 100]

BASIC AND COMBUSTION ENGINEERING

	Income			
BASIC	1977	1976	1975	1974
Amounts (000's)				
Net Sales	\$ 66,746	\$ 65,948	\$ 53,503	\$ 67,860
Net Income for Common	3,894	4,372	2,332	3,532
Net Cash Income for Common	6,689	6,940	4,518	5,875
Per Share				
Net Income	2.82	3.31	1.80	2.73
Net Cash Income	4.91	5.25	3.49	4.54

JA 519

COMBUSTION ENGINEERING

Amounts (000's)				
Net Sales	\$2,044,764	\$1,830,925	\$1,711,151	\$1,428,027
Net Income for Common	66,579	53,196	43,539	36,371
Net Cash Income for Common	106,209	85,193	72,248	63,133
Per Share				
Net Income	4.17	3.36	2.77	2.50
Net Cash Income	6.63	5.41	4.61	4.23

Note: Basic's income adjusted to eliminate ceramics net losses of \$265(000) in 1974.

BASIC AND COMBUSTION ENGINEERING

Relative Values

	BASIC	CE	BASIC > CE	MARKET VALUE CE @ \$32.375
Net Income				
1977	\$ 2.82	\$ 4.17	.68	\$22.02
1976	<u>3.31</u>	<u>3.36</u>	<u>.99</u>	<u>32.05</u>
2-Year Average	3.07	3.77	.81	\$26.22
1975	<u>1.80</u>	<u>2.77</u>	<u>.65</u>	<u>21.04</u>
3-Year Average	2.64	3.43	.77	24.93
1974	<u>2.73</u>	<u>2.50</u>	<u>1.09</u>	<u>35.29</u>
4-Year Average	2.66	3.20	.83	26.87
Net Cash Income				
1977	\$ 4.91	\$ 6.63	.74	\$23.96
1976	<u>5.25</u>	<u>5.41</u>	<u>.97</u>	<u>31.40</u>
2-Year Average	5.08	6.02	.84	27.20
1975	<u>3.49</u>	<u>4.61</u>	<u>.76</u>	<u>24.61</u>
3-Year Average	\$ 4.55	\$ 5.55	.82	\$26.55
1974	<u>4.54</u>	<u>4.23</u>	<u>1.07</u>	<u>34.64</u>
4-Year Average	\$ 4.55	\$ 5.22	.87	\$28.17

JA 520

	BASIC	CE	BASIC > CE	MARKET VALUE CE @ \$32.375
Dividend - Current	\$ 1.20	\$ 1.60	.75	\$24.28
Book Value (12/31/77)	\$21.40	\$27.30	.78	\$25.25
Market Price for 1977				
High	\$23.00	\$37.25	.61	\$19.75
Low	<u>19.50</u>	<u>31.75</u>	<u>.61</u>	<u>19.75</u>
Average	\$21.25	\$34.50	.62	\$20.07
Current at 3/28/78	\$ 20.125	\$32.375	.62	\$20.07

JA 521

BASIC AND COMBUSTION ENGINEERING

Balance Sheet

December 31, 1977

	BASIC		CE	
	AMOUNT	PERCENT	AMOUNT	PERCENT
(000's)				
NET ASSETS				
Net Current Assets				
Current Assets				
Cash and Equivalent	\$ 2,071		\$ 268,837	
Accounts Receivable	9,675		372,934	
Inventories	14,515		435,940	
Prepaid Items, etc.....	582		9,129	
Total	26,843		1,086,840	
Current Liabilities	7,383		994,840	
Net Current Assets.....	19,460	45.3	92,000	14.0
Net Fixed Assets				
Cost	66,517		721,479	
Less Depreciation	43,823		284,334	
Net Fixed Assets.....	22,694	52.9	437,145	66.3
Other Assets	733	1.8	130,287(a)	19.7
Net Assets	\$42,887	100.0	\$ 659,432	100.0

JA 522

	BASIC		CE	
	AMOUNT	PERCENT	AMOUNT	PERCENT
CAPITALIZATION				
Long-Term Debt	\$ 9,750	22.7	\$ 147,269	22.3
Reserves (Income Tax).....	-0-		69,243	10.5
Minority Interests.....	-0-		1,340	0.2
Shareholders' Equity				
Preferred Shares	3,588	8.4	1,442	0.2
Common Shares	29,549	68.9	440,138	66.8
Total Shareholders' Equity.	33,137	77.3	441,580	67.0
Total Capitalization	\$ 42,887	100.0	\$ 659,432	100.0
Common Shares Outstanding ..	1,387,383		15,867,532	

JA 523

(a) Includes \$67,873(000) goodwill.

JA 524

[PX66]

The New York Stock Exchange, Inc.

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623-3051

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623-5150

William R. Bors, Director
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Southern

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Nancy Nolan 623-5088
John-Paul Schrader 623-5489

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Mid-Western

LYNN ROHRBACH, Manager 623-[illegible]
David F. Dolan 623-[illegible]
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JA 525

SECURITIES SERVICES DEPARTMENT

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Richard M. Johns, Engraving
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John B. Kroog, Authorized
Signatures 623-5040
Stephen Walsh, Proxy Ratings 623-5030
John Segreno, Weekly Bulletin 623-5023

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SECTION A 2
LISTING AGREEMENTS

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SECTION A 2

Part I

TIMELY DISCLOSURE

Timely and Adequate Disclosure of Corporate News

A corporation whose securities are listed on the New York Stock Exchange Inc. is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for those securities. This is one of the most important and fundamental purposes of the listing agreement which each corporation enters into with the Exchange. The agreement is discussed in greater detail in the latter part of this Section beginning on page A-32.

A corporation should also act promptly to dispel unfounded rumors which result in unusual market activity or price variations.

The discussion which follows will assist a listed corporation in making adequate and timely disclosure to its shareholders, the financial community, and the investing public and thus provide the basis for a market for its securities which will be fair to all participants.

Exchange Market Surveillance

For its part, the Exchange maintains a continuous market surveillance program through its Division of Regulation and Surveillance. An "on-line" computer system has been developed which monitors the price movement of every listed stock—on a trade-to-trade basis—throughout the trading session. The program is designed to closely review the markets in those securities in which unusual price and volume changes occur or where there is a large unexplained influx of buy or sell orders. If the price movement of a stock exceeds a predetermined guideline, it is immediately "flagged" and a review of the situation is immediately undertaken to seek out the causes of the exceptional activity. Under such circumstances, the Company may be called by its Liaison Representative in the Division of Stock List to inquire about any company developments which have not been publicly announced but which could be responsible for unusual market activity. Where the market appears to be reflecting undisclosed information, the Corporation will normally be requested to make such information public immediately. Occasionally it may be necessary to carry out a stock watch inquiry after the fact and the Exchange may request such information from the Corporation as may be necessary to complete such an inquiry.

The listing agreement provides that the Corporation will furnish to the Exchange on demand such information concerning the Corporation as the Exchange may reasonably require.

SPECIAL INITIAL MARGIN AND CAPITAL REQUIREMENTS

Occasionally, a listed issue may be placed under special initial margin and capital requirements. Such a restriction in no way reflects upon the quality of corporate management, but, rather indicates a determination by the Floor Governors of the Exchange that the market in the issue has assumed a speculative tenor and has become volatile due to the influence of credit, which, if ignored, may lead to unfair and disorderly trading.

The determination to impose restrictions is based on a careful inspection of the trading for the latest one week period, defined as the previous Friday through subsequent Thursday, matched against various criteria. Basically, the issue must have traded an average 40,000 shares daily and have had a 10% price change. Other factors, such as the capitalization turnover, the ratio of last years average weekly volume to the volume for the period considered, arbitrage, stop order bans, short position, earnings and recent corporate news are also reviewed.

The restriction itself is aimed primarily at eliminating the extension of credit to those who buy a security and sell it the same day seeking a short term profit. Such customers must have the full purchase value in the account prior to the entry of an order. Concomitantly, a broader requirement is usually imposed on all other margin customers in that they must put up the full purchase price within five business days, rather than only the percentage required by the Federal Reserve Board. Cash customers, of course, must in all instances put up 100% of the cost in five days.

Corporate Liaison—Division of Stock List

The Division's organization groups Liaison Representatives into Regional Liaison teams. Each listed company is assigned to a team based upon the location of its executive offices. The Liaison Representatives serve as the focal point of all listed company contacts. When the Company's assigned representative is not available, other team members will handle any inquiry, so that there will be no unnecessary delay in attending to listed company matters. The Title page of this volume contains a list of the members of the regional liaison teams.

Preliminary discussions on important matters may be undertaken by listed company officials with the assurance that extreme security measures have been adopted by the Exchange to avoid revealing any confidential information which a listed company may disclose.

Internal Handling of Confidential Corporate Matters

Unusual market activity or a substantial price change has on occasion occurred in a company's securities shortly before the announcement of an important corporate action or development. Such incidents are extremely embarrassing and damaging to both the Company and the Exchange since the public may quickly conclude that someone acted on the basis of "inside" information.

Negotiations leading to acquisitions and mergers, stock splits, the making of arrangements preparatory to an exchange or tender offer, changes in dividend rates or earnings, calls for redemption, new contracts, products, or discoveries, are the type of developments where the risk of untimely and inadvertent disclosure of corporate plans is most likely to occur. Frequently, these matters require discussion and study by corporate officials before final decisions can be made. Accordingly, extreme care must be used in order to keep the information on a confidential basis.

WHERE IT IS POSSIBLE TO CONFINE FORMAL OR INFORMAL DISCUSSIONS TO A SMALL GROUP OF THE TOP MANAGEMENT OF THE COMPANY OR COMPANIES INVOLVED, AND THEIR INDIVIDUAL CONFIDENTIAL ADVISORS WHERE ADEQUATE SECURITY CAN BE MAINTAINED, PREMATURE PUBLIC ANNOUNCEMENT MAY PROPERLY BE AVOIDED. In this regard, the market action of a company's securities should be closely watched at a time when consideration is being given to important corporate matters. If unusual market activity should arise, the Company should be prepared to make an immediate public announcement of the matter.

At some point it usually becomes necessary to involve other persons to conduct preliminary studies or assist in other preparations for contemplated transactions, e.g., business appraisals, tentative financing arrangements, attitude of large outside holders, availability of major blocks of stock, engineering studies, market analysis and surveys, etc. Experience has shown that maintaining security at this point is virtually

impossible. Accordingly, fairness requires that the Company make an immediate public announcement as soon as confidential disclosures relating to such important matters are made to "outsiders."

The extent of the disclosures will depend upon the stage of discussion, studies, or negotiations. So far as possible, public statements should be definite as to price, ratio, timing and/or any other pertinent information necessary to permit a reasonable evaluation of the matter. As a minimum, they should include those disclosures made to "outsiders." Where an initial announcement cannot be specific or complete, it will need to be supplemented from time to time as more definitive or different terms are discussed or determined.

Corporate employees, as well as directors and officers, should be regularly reminded as a matter of policy that they must not disclose confidential information they may receive in the course of their duties and must not attempt to take advantage of such information themselves.

In view of the importance of this matter and the potential difficulties involved, the Exchange suggests that a periodic review be made by each company of the manner in which confidential information is being handled within its own organization. A reminder notice of the Company's policy to those in sensitive areas might also be helpful from time to time.

The effective implementation of the foregoing is essential to the maintenance of a fair and orderly securities market for the benefit of a company and its shareholders. It should minimize the occasions where the Exchange finds it necessary to temporarily halt trading in a security due to information leaks or rumors in connection with significant corporate transactions.

While the procedures are directed primarily at situations involving two or more companies, they are equally applicable to major corporate developments involving a single company. Announcements of this type should usually be handled by telephone alert to the Division of Stock List.

Relationship Between Company Officials and Security Analysts, Institutional Investors, etc.

Security analysts play an increasingly important role in the evaluation and interpretation of the financial affairs of listed companies. Annual reports, quarterly reports, and interim releases cannot by their nature provide all of the financial and statistical data that should be available to the investing public. The Exchange recommends that corporations observe an "open door" policy in their relations with security analysts, financial writers, shareowners, and others who have a legitimate investment interest in the company's affairs.

A company should not give information to one inquirer which it would not give to another. Nor should it reveal information it would not willingly give to the press for publication. Thus, for corporations to give advance earnings, dividend, stock split, merger, or tender information to analysts, whether representing an institution, brokerage house, investment advisor, large stockholder, or anyone else, would be clearly incompatible with Exchange policy. On the other hand, it should not withhold information in which analysts or other members of the investing public have a warrantable interest.

If during the course of a discussion with analysts substantive material not previously published is disclosed, that material should be simultaneously released to the public. The various security analysts societies usually have a regular procedure to be followed where formal presentations are made. The company should follow these same precautions when dealing with groups of industry analysts in small or closed meetings.

The competent analyst depends upon his professional skills and broad industry knowledge in making his evaluations and preparing his reports and does not need the type of inside information that could lead to unfairness in the marketplace.

Relationship Between Company Officials and Personnel of New York Stock Exchange Member Organizations Serving as Directors or Advisors to the Corporation

The following excerpt from Member Firm Educational Circular No. 162 of June 22, 1962 sets forth Exchange policy in these relationships:

"Every director has a fiduciary obligation not to reveal any privileged information to anyone not authorized to receive it. Not until there is full public disclosure of such data, particularly when the information might have a bearing on the market price of the securities, is a director released from the necessity of keeping information of this character to himself. Any director of a corporation who is a partner, officer, or employee of a member organization should recognize that his first responsibility in this area is to the corporation on whose Board he serves. Thus, a member firm director must meticulously avoid any disclosure of inside information to his partners, employees of the firm, his customers or his research or trading departments."

Where a representative of a member organization is not a director but is acting in an advisory capacity to a company and discussing confidential matters, the ground rules should be substantially the same as those that apply to a director. Should the matter require consultation with other personnel of the organization, adequate measures should be taken to guard the confidential nature of the information to prevent its misuse within or outside of the member organization.

A booklet entitled, "The Corporate Director and The Investing Public" is available from the Exchange on request of listed companies.

PART II

PROCEDURE FOR PUBLIC RELEASE OF INFORMATION

Immediate Release Policy

The normal method of publication of important corporate data is by means of a press release. This may be either by telephone or in written form. Any release of information that could reasonably be expected to have an impact on the market for a company's securities should be given to the wire services and the press FOR IMMEDIATE RELEASE. Clearly, a corporation cannot properly assume responsibility for the security of such important information in the hands of persons or organizations beyond its control.

The spirit of the IMMEDIATE RELEASE policy is not considered to be violated on weekends where a "Hold for Sunday or Monday A.M.'s" is used to obtain a broad public release of the news. This procedure facilitates the combination of a press release with a mailing to shareholders.

Annual and quarterly earnings, dividend announcements, acquisitions, mergers, tender offers, stock splits, and major management changes, and any substantial items of unusual or non-recurrent nature are examples of news items that should be handled on an immediate release basis. News of major new products, contract awards, expansion plans, and discoveries very often fall into the same category. Unfavorable news should be reported as promptly and candidly as the favorable. Reluctance or unwillingness to release a negative story or an attempt to disguise unfavorable news endangers a management's reputation for integrity. Changes in accounting methods to mask such occurrences can have a similar long-term impact.

It should be a corporation's primary concern to assure that news will be handled in proper perspective. This necessitates appropriate restraint, good judgment, and careful adherence to the facts. Any projection of financial data, for instance, should be soundly based, appropriately qualified, conservative and factual. Excessive or misleading conservatism should be

avoided. Likewise, the repetitive release of essentially the same information is not appropriate.

Few things are more damaging to a corporation's stockholder relations or to the general public's regard for corporate securities than information improperly withheld whether inadvertently or willfully. On the other hand, a mere deluge of press releases is not to be used since important items can become confused with trivia.

Premature announcements of new products whose commercial application cannot yet be realistically evaluated should be avoided. So should overly optimistic forecasts, exaggerated claims and unwarranted promises. And should subsequent developments indicate that performance will not match earlier projections, this too should be reported and explained.

Judgment must be exercised as to the timing of a public release on those corporate developments where the immediate release policy is not involved or where disclosure would endanger the company's goals or provide information helpful to a competitor. In these cases, it is helpful to weigh the fairness to both present and potential stockholders who at any given moment may be considering buying or selling the company's stock.

Dealing with Rumors or Unusual Market Activity

The market action of a Corporation's securities should be closely watched at a time when consideration is being given to significant corporate matters. If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required. If rumors are in fact false or inaccurate, they should be promptly denied or clarified. A statement to the effect that the company knows of no corporate developments to account for the unusual market activity can have a salutary effect. It is obvious that if such a public statement of this sort was contemplated, all levels of management should be checked prior to any public comment so as to avoid any embarrassment or potential criticism. If rumors are correct or there are

developments, an immediate, candid statement to the public as to the state of negotiations or the state of development of corporate plans in the rumored area must be made directly and openly. Such statements are essential despite the business inconvenience which may be caused and even though the matter may not as yet have been presented to the company's Board of Directors for consideration.

The Exchange recommends that its listed companies contact their Liaison Representative if they become aware of rumors circulating about their company. Exchange rule 435 provides that no member, member organization or allied member shall circulate in any manner rumors of a sensational character which might reasonably be expected to affect market conditions on the Exchange. Information provided concerning rumors will be promptly investigated.

TELEPHONE ALERT TO THE DIVISION OF STOCK LIST OF THE EXCHANGE

When the announcement of news of a material event or a statement dealing with a rumor which calls for IMMEDIATE RELEASE is made shortly before the opening or during market hours (normally 10 a.m. to 4:00 p.m., New York time), it is recommended that the Division of Stock List of the Exchange be notified by telephone at least ten minutes prior to the release of the announcement to the news media. If the Exchange receives such notification in time, it will be in a position to consider whether, in the opinion of the Exchange, trading in the security should be halted temporarily. A delay in trading, which normally would last about 30 minutes after the appearance of the news on the Dow-Jones or Reuters news wires, provides a period for the public evaluation of the announcement. The halt also allows open limit orders on the specialist book to be adjusted by investors in view of a news announcement. Even if limit orders are not cancelled or changed during the halt, the fact that trading is halted results in the reopening being considered a new opening, thereby, enabling limit orders to participate at the new opening price

regardless of the previously entered limit. A longer delay in trading may be necessary if there is an unusual influx of orders. The Exchange attempts to keep such interruptions in the continuous auction market to a minimum. However, where events transpire during market hours, the overall importance of fairness to all those participating in the market demands that these procedures be followed.

The direct dial telephone numbers of the Division of Stock List personnel of the Exchange appear on the Title Page of this Manual. Normally, the call should be directed to the Liaison Representative assigned to the Company. A telephone alert should be confirmed promptly in writing.

Release to Newspapers and News Wire Services

News which ought to be the subject of immediate publicity must be released by the fastest available means. The "fastest available means" may vary in individual cases and according to the time of day. Ordinarily, this requires a release to the public press by telephone, telegraph, or hand delivery, or some combination thereof. Transmittal of such a release to the press solely by mail is not considered satisfactory. Similarly, release of such news exclusively to the local press outside of New York City would not be sufficient for adequate and prompt disclosure of the investing public.

To insure adequate coverage, releases requiring immediate publicity should be given to Dow Jones & Company, Inc., and to Reuters Economic Services.

The foregoing distribution of releases should be regarded as a minimum. Companies are encouraged to give additional prompt distribution of their releases to Associated Press and United Press International as well as to newspapers in New York City and in cities where the Corporation is headquartered or has plants or other major facilities.

A copy of any such press release should be sent promptly to the Exchange, to the attention of the Company's Liaison Representative in the Division of Stock List.

The New York City addresses and telephone numbers of these national news-wire services are:

Associated Press, 50 Rockefeller Plaza, 262-7880; after 7:00 p.m., 262-6093.

Dow Jones & Company, Inc., 22 Cortlandt St., 285-5000.

Reuters Economic Services, 1212 Avenue of Americas, 581-4250; after 6:30 p.m., 582-4030.

United Press International, 220 East 42 Street, MUrray Hill 2-0400, Ext. 371; after 6:00 p.m., Ext. 325.

It is suggested that every news release include the name and telephone number of a company official who will be available if a newspaper or news wire service desires to confirm or clarify the release with the company.

Part III

DIRECTOR AND OFFICER—STOCK TRANSACTIONS

Many stockholders feel that directors and officers should have a meaningful investment in the companies they manage. The extent of this ownership, naturally, would vary in accordance with the financial circumstances of the persons involved. As shareowners themselves, directors are more likely to represent the viewpoint of other shareowners whose interests they are charged with protecting. Similarly, officers—the executive management group—may well perform more effectively with the incentive of stock options or a share in the equity ownership of the corporation.

The Exchange has encouraged the broadening of shareownership through stock option and employee stock purchase plans, especially those plans that include all or a large portion of the company's employees. The approval of stockholders has been a prerequisite of Exchange listing of new shares for the more limited key officer plans.

However, the widespread endorsement of director and officer shareownership brings with it questions that concern the

timing of their stock transactions. When may a director or officer properly buy or sell shares of his company's stock? When is it appropriate to award stock options to key executives? There is no simple, uniform answer to these questions, but they do underscore the importance of a policy of adequate and timely disclosure both for the benefit of the investing public and for the protection of management.

Competition requires that companies engage in active programs of research, development, and exploration. For many companies, more than half of today's sales represent new products or services invented, discovered, developed, or radically redesigned during the last ten years. Nevertheless, more experimental projects fail than result in salable and profitable products or services. Public disclosure at the earlier stages of new developments may be premature. In addition, competition and the best interests of the company and its shareholders may require a veil of secrecy around new developments before they reach the stage where public disclosure is appropriate. Still, hindsight is remarkably keen and the accusation can always be made that a purchase or sale of stock by a director was dictated by inside knowledge of a future favorable or unfavorable development. *This theory, carried to its extreme, might suggest that a corporate official should never buy or sell stock in the company he represents.*

But to reiterate, stockholders have indicated that they want officers and directors to have a meaningful investment in the companies they manage. So, in the interest of promoting better stockholder relationships, some rule of thumb under which corporate officials may properly buy or sell stock in their company would be helpful. Considerations which may be pertinent in approaching this question are outlined in the paragraphs which follow.

1. One appropriate method of purchase might be a periodic investment program where the officer or director makes regular purchases under an established program administered by a broker and where the timing of purchases is outside the control of the individual.

2. It would also seem appropriate for officials to buy or sell stock in their companies for a 30-day period commencing one week after the annual report has been mailed to stockholders and otherwise broadly circulated (provided, of course, that the annual report has adequately covered important corporate developments and that no new major undisclosed developments occur within that period).
3. Transactions may also be appropriate under the following circumstances, provided that prior to making a purchase or sale an officer or director contacts the chief executive officer of the company to find out if there are any important developments pending which need to be made public before an insider could properly participate in the market.
 - (a) Following a release of quarterly results, which includes adequate comment on new developments during the period. This timing of transactions might be even more appropriate where the report has been mailed to shareholders.
 - (b) Following the wide dissemination of information on the status of the company and current results. For example, after a proxy statement or prospectus which gives such information in connection with a merger or new financing.
 - (c) At those times when there is relative stability in the company's operations and the market for its securities. Under these circumstances, timing of transactions may be relatively less important. Of course such periods of relative stability will vary greatly from time to time and will also depend to a large extent on the nature of the industry or the company.

If the size of a purchase or sale is substantial, say more than \$30,000 within a 3-month period, the preferable course of

action might be to make such a purchase or sale in the time period outlined in (2) above.

Where a development of major importance is expected to reach the appropriate time for announcement within the next few months, transactions by officers and directors should probably be avoided.

Corporate officials should wait until after the release of earnings, dividends, or other important developments have appeared in the press before making a purchase or sale. This permits the news to be widely disseminated and negates the inference that officials had an inside advantage. Similarly, transactions just prior to important press releases should probably be avoided.

In granting stock options to key officers and directors, the same philosophy that relates to purchases and sales may well apply. Where an established pattern or formula is part of a plan specifically approved by shareholders, the question of timing may not arise. In taking up an option, the timing of a purchase is not usually critical as the price is set at the time the option is granted. The reasoning relating to stock options might also apply to employee stock purchase plans in which officers and directors may be entitled to participate.

The considerations that affect officer and director transactions in stock of their own company may be pertinent to transactions in the shares of other companies with whom discussions of acquisition, merger, or important contracts, etc., are being considered or carried on.

The same considerations apply to the families or close associates of officers and directors who are often presumed to have preferential access to information. As far as the public is concerned, these also are insiders. And while this assumption may be unjustified in many cases, it is a fact of life which those in positions of leadership and responsibility cannot ignore.

Some companies have adopted policies for the guidance of their personnel relating to transactions in the company's stock, as well as other areas where conflicts of interest could arise. Such policies can be very helpful to employees who have access

to important confidential information, as well as to the officers and directors.

In the final analysis, directors and officers must be guided by a sense of fairness to all segments of the investing public.

Within the framework of any policies adopted by his company, the final decision of each officer and director with respect to securities transactions must be his own. Each case must ultimately stand or fall on its own merits. No single rule could possibly cover all situations; nor should unnecessary restrictions be permitted to discourage shareowners among these business leaders who play such a vital role in the success of our system of free enterprise.

Particular attention is directed to Section 10b and 16 of the Securities Exchange Act of 1934 and rule 10b-5 of the Securities and Exchange Commission.

Part IV

CONFLICTS OF INTEREST

The following is an excerpt from the Exchange publication "The Corporate Director and the Investing Public."

Conflicts of interest are usually the major topic of discussion whenever the broad question of ethical business conduct arises. Directors, officers, employees, and the families and close friends of each of these groups all may become involved in these problems. The comments here are limited primarily to those aspects affecting directors and officers.

A director's fiduciary responsibility to shareholders takes on greater importance in a publicly owned than in a privately owned company. Transactions or relationships which may be entirely appropriate in a closely held company may be totally unacceptable after the public has been invited to participate in the ownership.

A publicly owned company of the size and character appropriate for listing on the New York Stock Exchange should be able to operate on its own merit and credit standing. It should

be free from the suspicion which may arise when business transactions are consummated with insiders.

Attempts are sometimes made to justify continuing conflicts of interest. For example, independent appraisals may be made or the person having the interest may refrain from voting or otherwise participating in the decision-making process. Nevertheless, there remains a delicate question of whether any arrangement would have been made at all if the person with the interest were neither an officer nor a director.

The argument has been advanced that a continuing arrangement with an insider represents a better deal for the company than could be negotiated at arms' length. However, even though an arrangement might have been equitable or favorable when entered into, it may be continued after it has ceased to be favorable. In addition, times change and such arrangements must often be renegotiated before they expire. Whenever these involve insiders, conflicting interests are unavoidably present.

The question of conflicts of interest involves both moral and legal values. This interplay has found its way into court decisions as evidenced by quotes from two well-known cases which follow:

The Supreme Court of Delaware in April 1939¹ said:

"Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that

requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest."

In another context, the U.S. Supreme Court² said in 1961:

"The moral principle upon which the statute is based has its foundation in the Biblical admonition that no man may serve two masters. Matt 6:24, a maxim which is especially pertinent if one of the masters happens to be economic self-interest . . . The statute is thus directed not only at dishonor, but also at conduct that tempts dishonor. This broad proscription embodies a recognition of the fact that an impairment of impartial judgment can occur in even the most well-meaning men when their personal and economic interests are affected by the business they transact on behalf of the United States Government. To this extent, therefore, the statute is more concerned with what might have happened in a given situation than with what actually happened."

Most companies listed on this Exchange have either written or unwritten policies strictly prohibiting any relationship that might be construed as a conflict of interest. In those relatively rare instances where the problem arises, it usually involves companies in the earlier stages of evolution from private to public ownership or those in which a family group still holds a major block of the outstanding stock. The question may also arise in connection with an acquisition or merger where conflicts exist in the other company.

In considering the eligibility of companies for original listing, the Exchange recognizes that each company must be treated on an individual basis. Thus, where a conflict of interest exists that can be resolved promptly, the Exchange expects that it be cleared up prior to listing. In more complicated cases—such as where property is leased and where time may be required to work out complex details—the Exchange requests an agreement that the conflict will be terminated within a reasonable period (usually two to five years).

Once they are listed, companies obviously are expected to conduct their affairs in such a manner as to prevent conflicting interests from arising either in their own operations or in connection with companies they acquire by acquisition or merger. Where unusual circumstances make an isolated "non-arms' length" transaction unavoidable, stockholder approval should be obtained to reduce objections to a minimum.*

In the experience of the Exchange, conflict of interest problems involving officers and directors (or members of their families) most frequently concern (1) the direct or indirect ownership of property leased to the company; (2) sales or purchases of goods or services to or from organizations in which an officer (or major shareholder) has a material direct or indirect interest; and (3) the ownership by officers or directors of the parent company of a portion of the minority equity in subsidiaries (excepting of course, directors' qualifying shares or other nominal interests). Generally speaking, relationships of this nature are undesirable.

Part V

AUDIT COMMITTEE POLICY

Each domestic company with common stock listed on the Exchange, as a condition of listing and continued listing of its securities on the Exchange, shall establish no later than June 30, 1978 and maintain thereafter an Audit Committee comprised solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member. Directors who are affiliates of the company or officers or employees of the company or its subsidiaries would not be qualified for Audit Committee membership.

* Transactions with officers, directors, or major share holders (5% or more) are considered as "non-arms' length" for this purpose.

A director who was formerly an officer of the company or any of its subsidiaries may qualify for membership even though he may be receiving pension or deferred compensation payments from the company if, in the opinion of the Board of Directors, such person will exercise independent judgment and will materially assist the function of the committee. However, a majority of the Audit Committee shall be directors who were not formerly officers of the company or any of its subsidiaries.

Supplementary Material

In order to deal with the complex relationships that arise, the following guidelines are provided to assist Boards of Directors to observe the spirit of the policy in selecting members of the Audit Committee.

A director who has, or is a partner, officer or director of an organization that has customary commercial, industrial, banking or underwriting relationships with the company which are carried on in the ordinary course of business on an arms-length basis may qualify for membership unless, in the opinion of the Board of Directors, such director is not independent of management or the relationship would interfere with the exercise of independent judgment as a committee member.

A director who, in addition to fulfilling the customary director's role, also provides additional services directly for the Board of Directors and is separately compensated therefor, would nonetheless qualify for membership on the Audit Committee. However, a director who, in addition to his director's role, also acts on a regular basis as an individual or representative of an organization serving as a professional advisor, legal counsel or consultant to management, would not qualify if, in the opinion of the Board of Directors, such relationship is material to the company, the organization represented or the director.

A director who represents or is a close relative of a person who would not qualify as a member of the Audit Committee in the light of the policy would likewise not qualify for the committee. However, if the director is a close relative of an

employee who is not an executive officer or if there are valid countervailing reasons, the Board of Directors' decision as to eligibility shall govern.

While SEC Rule 405 may be helpful to the Board of Directors in determining whether a particular director is an "affiliate" or a close relative for purposes of this policy, it is not intended to be so technically applied as to go beyond the spirit of this policy.

Adopted by the Board of Directors, January 6, 1977.

Part VI

DEFENSIVE TACTICS

For many years the Exchange has encouraged the broadening of shareownership in a climate of corporate democracy and has endeavored to preserve the basic right of stockholders to participate in the corporate affairs of the companies which they own by requiring an informed and convenient method of voting in proportion to their investment in the Company. Since 1926 the Exchange has refused to list non-voting common stock and currently will delist the voting common stock of a company which creates a class of non-voting common stock or fails to solicit proxies for meetings of its stockholders. All common stocks listed on the Exchange have the right to vote.

The Exchange has an ongoing concern as to the possible implications of certain so-called "defensive tactics" which would in effect discriminate between shareholders.

Generally speaking, an arrangement which could be applied uniformly to all transactions of similar nature and without regard to the parties involved, normally, would not be viewed as objectionable. On the other hand, any proposal which results in either discrimination against an existing substantial stockholder or discouragement of anyone seeking to make a substantial investment would appear to raise substantial questions as to whether or not it constitutes an infringement upon the voting philosophy of the Exchange.

As a matter of policy, the Exchange will refuse to list common stock when restrictions are involved such as voting trusts, irrevocable proxies, disproportionate voting power, classification of boards of directors into more than three classes of approximately equal size and tenure, or unusual voting provisions which tend to nullify or restrict the voting of a class of stock or the right to veto the action of another class.

It is suggested that companies consult with the Division of Stock List while corporate planning is in an early stage to be certain that Exchange voting rights policies are not violated. In any event copies of preliminary proxy materials should be furnished to the Exchange for review, preferably before formal filing. This will avoid problems that otherwise might arise as to a company's continued listing status.

The foregoing is condensed from two letters to Presidents of Listed Companies dated in 1968 and 1969 which formerly were included under the Current Matters Section.

PART VII

LISTING AGREEMENT

Development of the Listing Agreement

Since 1899, companies making application for the listing of their securities have, as a regular part of the listing procedure, entered into a Listing Agreement with the Exchange by which they commit themselves to a code of performance, after listing, in respect of the matters dealt with by the agreement.

At the outset the items in the agreement were few in number, and restricted in scope. Initially there were only three, two of which were concerned with mechanical necessities of the market-place—the maintenance of transfer facilities and advance notice of record dates.

The third item represented the Exchange's effort to satisfy, by a formal requirement, a public need which it had long recognized, but which its previous, unsupported efforts had been unable to fill—the need of investors for regular financial

reports by the companies whose securities they held. Supported by a rising popular demand for such information and the beginning of a show of interest by corporate managements, the Exchange sought, through the medium of the newly-born Listing Agreement, to make the regular publication of annual financial statements a standard practice among listed companies. Now, with almost all listed companies publishing quarterly reports of earnings, it is interesting to note that in 1866, the Exchange, when requesting financial statements of a well-known company of that day, was told by the company that it "made no reports and published no statements and had not done anything of the kind for the last five years."

From that beginning, as corporate policies and practices, and those of the securities industry, advanced and grew more complex, and as the areas of warrantable public interest in corporate affairs broadened and became more clearly defined, the Listing Agreement advanced, and expanded in scope as well as in number of requirements.

While that expansion, as measured from its beginning in 1899, has been considerable, it has also been gradual, in pace with the development of public policy in the fields of corporation finance and management, and in the fields of stockholder relations and accounting. New requirements have been added only as the need for remedial measures and the appropriate, practical means of applying those measures became evident, or as they became useful in promotion of a trend toward improved practice among leading corporations. It has been gradual because the Exchange, through the years, as now, has been loath to adopt any new requirement affecting listed companies until that requirement has been proved to be not only sound in principle, and an advancement of the public interest, but thoroughly workable, as well.

Current Agreement as a Guide

One result of the evolutionary process by which the Listing Agreement has developed is that not all companies have an identical agreement with the Exchange. The Listing Agreement

as a whole is only renewed upon the occasion of an application for listing, and the exact form of the Agreement executed by any one company depends upon just when it last made an application for listing any of its securities, and upon the form of Agreement then standard.

However, the form of Agreement now standard (which is reproduced below in this Section of the Manual) is indicative of current concepts of good practice, and of what is currently necessary or desirable, in respect to the matters with which it deals. The Exchange urges every listed company to be guided by the current standard form of agreement in the matters on which it bears, even though the specific agreement last executed by it may have been less comprehensive.

One of the most important and fundamental purposes and intents of the agreement, in combination with other procedures and policies of the Exchange, is to assure that adequate and timely publicity is given to matters concerning listed companies of significance to the investing public. Reports made to the Exchange pursuant to the listing agreement may be made available to the public and the press by the Exchange. However, the Exchange normally expects a corporation to handle all of its own press releases.

The principles underlying the agreement may also be useful as a guide in matters not specifically covered by it. In order to make it generally applicable, and to hold the requirements within a reasonable number, it is restricted to matters of more or less common occurrence in the affairs of large, publicly-owned companies. In all probability there will arise, from time to time, unusual situations, not specifically covered by any paragraph of the agreement. The Exchange urges listed companies to be guided in such situations, by the principles exhibited by the listing agreement.

Objectives of the Agreement

Upon study of the current form of listing agreement, as reproduced below, it will become evident that, in general, it seeks to achieve the following objectives:

1. Timely disclosure, to the public and to the Exchange, of information that may affect security values or influence investment decisions, and in which stockholders, the public and the Exchange have a warrantable interest; (see detailed discussion of this subject in the first part of this Section).
2. Frequent, regular and timely publication of financial reports prepared in accordance with accepted accounting practice, and in adequate (but not burdensome) detail;
3. Providing the Exchange with timely information to enable it to perform, efficiently and expeditiously, its function of maintaining an orderly market for the company's securities and to enable it to maintain its necessary records;
4. Preclusion of certain practices not generally considered sound;
5. Allowing the Exchange opportunity to make representations as to certain matters before they become accomplished facts.

On the basis of more than seventy years' experience with the listing agreement, and constant study of its effect, the Exchange believes that the assurance investors derive from the agreement, and from the demonstration of intention corporate management makes in assuming the obligations of the agreement, contributes substantially to the marked preference shown by the public for securities listed on the New York Stock Exchange.

Administration of the Agreement

Naturally, the Exchange looks for strict observance of the listing agreement. However, it is realized that, occasionally, conditions will arise which make literal compliance with one, or another, of its requirements difficult, if not impossible. In such a case the Exchange is inclined to place the emphasis upon

the spirit, rather than upon the letter, of the agreement, and will endeavor to work out with the company some way of relieving the difficulty, while preserving the purpose of the agreement.

If, in a particular situation, it should appear that there may be some difficulty in compliance with a particular requirement of the agreement, the matter should be brought to the attention of the Division of Stock List of the Exchange as soon as the possibility of difficulty becomes apparent.

Current Form of Listing Agreement

Nothing in the following Agreement shall be so construed as to require the Issuer to do any acts in contravention of law or in violation of any rule or regulation of any public authority exercising jurisdiction over the Issuer.

..... (hereinafter called the "Corporation"), in consideration of the listing of the securities covered by this application, hereby agrees with the New York Stock Exchange (hereinafter called the "Exchange"), as follows:

I

1. The Corporation will promptly notify the Exchange of any change in the general character or nature of its business.
2. The Corporation will promptly notify the Exchange of any changes of officers or directors.
3. The Corporation will promptly notify the Exchange in the event that it or any company controlled by it shall dispose of any property or of any stock interest in any of its subsidiary or controlled companies, if such disposal will materially affect the financial position of the Corporation or the nature or extent of its operations.
4. The Corporation will promptly notify the Exchange of any change in, or removal of, collateral deposited under any mortgage or trust indenture, under which securities of the Corporation listed on the Exchange have been issued.

5. The Corporation will:

- a. File with the Exchange four copies of all material mailed by the Corporation to its stockholders with respect to any amendment or proposed amendment to its Certificate of Incorporation.
- b. File with the Exchange a copy of any amendment to its Certificate of Incorporation, or resolution of Directors in the nature of an amendment, certified by the Secretary of the state of incorporation, as soon as such amendment or resolution shall have been filed in the appropriate state office.
- c. File with the Exchange a copy of any amendment to its By-Laws, certified by a duly authorized officer of the Corporation, as soon as such amendment shall have become effective.

6. The Corporation will disclose in its annual report to shareholders, for the year covered by the report, (1) the number of shares of its stock issuable under outstanding options at the beginning of the year; separate totals of changes in the number of shares of its stock under option resulting from issuance, exercise, expiration or cancellation of options; and the number of shares issuable under outstanding options at the close of the year, (2) the number of unoptioned shares available at the beginning and at the close of the year for the granting of options under an option plan, and (3) any changes in the exercise price of outstanding options, through cancellation and reissuance or otherwise, except price changes resulting from the normal operation of antidilution provisions of the options.

7. The Corporation will report to the Exchange, within ten days after the close of a fiscal quarter, in the event any previously issued shares of any stock of the Corporation listed on the Exchange have been reacquired or disposed of, directly or indirectly, for the account of the Corporation during such fiscal quarter, such report showing separate totals of acquisitions and dispositions and the number of shares of such stock so held by it at the end of such quarter.

8. The Corporation will promptly notify the Exchange of all facts relating to the purchase, direct or indirect, of any of its securities listed on the Exchange at a price in excess of the market price of such security prevailing on the Exchange at the time of such purchase.

9. The Corporation will not select any of its securities listed on the Exchange for redemption otherwise than by lot or pro rata, and will not set a redemption date earlier than fifteen days after the date corporate action is taken to authorize the redemption.

10. The Corporation will promptly notify the Exchange of any corporate action which will result in the redemption, cancellation or retirement, in whole or in part, of any of its securities listed on the Exchange, and will notify the Exchange as soon the Corporation has notice of any other action which will result in any such redemption, cancellation or retirement.

11. The Corporation will promptly notify the Exchange of action taken to fix a stockholders' record date, or to close the transfer books, for any purpose, and will take such action at such time as will permit giving the Exchange at least ten days' notice in advance of such record date or closing of the books.

12. In case the securities to be listed are in temporary form, the Corporation agrees to order permanent engraved securities within thirty days after the date of listing.

13. The Corporation will furnish to the Exchange on demand such information concerning the Corporation as the Exchange may reasonably require.

14. The Corporation will not make any change in the form or nature of any of its securities listed on the Exchange, nor in the rights or privileges of the holders thereof, without having given twenty days' prior notice to the Exchange of the proposed change, and having made application for the listing of the securities as changed if the Exchange shall so require.

15. The Corporation will make available to the Exchange, upon request, the names of member firms of the Exchange

which are registered owners of stock of the Corporation listed on the Exchange if at any time the need for such stock for loaning purposes on the Exchange should develop, and in addition, if found necessary, will use its best efforts with any known large holders to make reasonable amounts of such stock available for such purposes in accordance with the rules of the Exchange.

16. The Corporation will promptly notify the Exchange of any diminution in the supply of stock available for the market occasioned by deposit of stock under voting trust agreements or other deposit agreements, if knowledge of any such actual or proposed deposits should come to the official attention of the officers or directors of the Corporation.

17. The Corporation will make application to the Exchange for the listing of additional amounts of securities listed on the Exchange sufficiently prior to the issuance thereof to permit action in due course upon such application.

II

1. The Corporation will publish at least once a year and submit to its stockholders at least fifteen days in advance of the annual meeting of such stockholders and not later than three months after the close of the last preceding fiscal year of the Corporation a balance sheet as of the end of such fiscal year, and a surplus and income statement of such fiscal year of the Corporation as a separate corporate entity and of each corporation in which it holds directly or indirectly a majority of the equity stock; or in lieu thereof, eliminating all intercompany transactions, a consolidated balance sheet of the Corporation and its subsidiaries as of the end of its last previous fiscal year, and a consolidated surplus statement and a consolidated income statement of the Corporation and its subsidiaries for such fiscal year. If any such consolidated statement shall exclude corporations a majority of whose equity stock is owned directly or indirectly by the Corporation: (a) the caption of, or a note to, such statement will show the degree of

consolidation; (b) the consolidated income account will reflect, either in a footnote or otherwise, the parent company's proportion of the sum of, or difference between, current earnings or losses and the dividends of such unconsolidated subsidiaries for the period of the report; and (c) the consolidated balance sheet will reflect, either in a footnote or otherwise, the extent to which the equity of the parent company in such subsidiaries has been increased or diminished since the date of acquisition as a result of profits, losses and distributions.

Appropriate reserves, in accordance with good accounting practice, will be made against profits arising out of all transactions, with unconsolidated subsidiaries in either parent company statements or consolidated statements.

Such statements will reflect the existence of any default in interest, cumulative dividend requirements, sinking fund or redemption fund requirements of the Corporation and of any controlled corporation, whether consolidated or unconsolidated.

2. All financial statements contained in annual reports of the Corporation to its stockholders will be audited by independent public accountants qualified under the laws of some state or country, and will be accompanied by a copy of the certificate made by them with respect to their audit of such statements showing the scope of such audit and the qualifications, if any, with respect thereto.

The Corporation will promptly notify the Exchange if it changes its independent public accountants regularly auditing the books and accounts of the Corporation.

3. All financial statements contained in annual reports of the Corporation to its stockholders shall be in the same form as the corresponding statements contained in the listing application in connection with which this Listing Agreement is made, and shall disclose any substantial items of unusual or non-recurrent nature.

4. The Corporation will publish quarterly statements of earnings on the basis of the same degree of consolidation as in

the annual report. Such statements will disclose any substantial items of unusual or non-recurrent nature and will show either net income before and after federal income taxes or net income and the amount of federal income taxes.

5. The Corporation will not make, nor will it permit any subsidiary directly or indirectly controlled by it to make, any substantial charges against capital surplus, without notifying the Exchange. If so requested by the Exchange, the Corporation will submit such charges to stockholders for approval or ratification.

6. The Corporation will not make any substantial change, nor will it permit any subsidiary directly or indirectly controlled by it to make any substantial change, in accounting methods, in policies as to depreciation and depletion or in bases of valuation of inventories or other assets, without notifying the Exchange and disclosing the effect of any such change in its next succeeding interim and annual report to its stockholders.

7. The Corporation will maintain an audit committee in conformity with Exchange requirements (effective 6-30-78).

III

1. The Corporation will maintain an office or agency satisfactory to the Exchange:

a. An office or agency where the principal of and interest on all bonds of the Corporation listed on the Exchange shall be payable and where any such bonds which are registerable as to principal or interest shall be accepted for the purpose of transfer.

b. An office or agency where

(1) All stock of the Corporation listed on the Exchange will be accepted for the purpose of transfer.

(2) Checks for dividends and other payments with respect to stock listed on the Exchange shall be payable.

(3) Scrip issued to holders of a security listed on the Exchange and representing a fractional interest in a security listed on the Exchange will, during the period provided for consolidation thereof, be accepted for such purpose.

(4) A security listed on the Exchange which is convertible or called for redemption will be accepted for conversion, or redemption.

(5) Subscription rights issued to holders of listed stock of the company will be accepted for this purpose if transfer or payment and securities subscribed for shall be deliverable; and where all other rights or benefits pertaining to ownership of listed stock of the company, which may be issued, granted or allotted by the Company, shall be accepted for transfer, exercise, payment and delivery.

If the transfer books for a security of the Corporation listed on the Exchange should be closed permanently, the Corporation will continue to split up certificates for such security into certificates of smaller denominations in the same name so long as such security continues to be dealt in on the Exchange.

If checks for dividends or other payments with respect to stock listed on the Exchange are drawn on a bank located outside the City of New York, the Corporation will also make arrangements for payment of such checks at a bank, trust company or other agency located in the Borough of Manhattan, City of New York. The name and address of such New York agency should be imprinted on such checks or printed on an enclosed explanatory note.

c. A registrar where stock of the Corporation listed on the Exchange shall be registerable. Such registrar shall be a bank or trust company not acting as transfer agent for the same security.

2. The Corporation will not appoint a transfer agent, registrar or fiscal agent of, nor a trustee under a mortgage or other instrument relating to, any security of the Corporation listed

on the Exchange without prior notice to the Exchange, and the Corporation will not appoint a registrar for its stock listed on the Exchange unless such registrar, at the time of its appointment becoming effective, is qualified with the Exchange as a registrar for securities listed on the Exchange; nor will the Corporation select an officer or director of the Corporation as a trustee under a mortgage or other instrument relating to a security of the Corporation listed on the Exchange.

3. The Corporation will have on hand at all times a sufficient supply of certificates to meet the demands for transfer. If at any time the stock certificates of the Corporation do not recite the preferences of all classes of its stock, it will furnish to its stockholders, upon request and without charge, a printed copy of preferences of all classes of such stock.

4. The Corporation will publish immediately to the holders of any of its securities listed on the Exchange any action taken by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange; and will give prompt notice to the Exchange of any such action; and will afford the holders of its securities listed on the Exchange a proper period within which to record their interests and to exercise their rights; and will issue all such rights or benefits in form approved by the Exchange and will make the same transferable, exercisable, payable and deliverable in the Borough of Manhattan in the City of New York.

5. The Corporation will solicit proxies for all meetings of stockholders.

6. The Corporation will issue new certificates for securities listed on the Exchange replacing lost ones forthwith upon notification of loss and receipt of proper indemnity. In the event of the issuance of any duplicate bond to replace a bond which has been alleged to be lost, stolen or destroyed and the subsequent appearance of the original bond in the hands of an innocent bondholder, either the original or the duplicate bond will be taken up and cancelled and the Corporation will deliver

JA 560

to such holder another bond theretofore issued and outstanding.

7. The Corporation will pay when due any applicable Listing Fees established from time to time by the Exchange.

.....
By

Date

PETITIONER'S BRIEF

APR 30 1987

JOSEPH F. SPANIOL, JR.
CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust, and
RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR PETITIONERS

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QUESTIONS PRESENTED

1. Did the Court of Appeals err, in an action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, in holding that statements by a company denying the existence of merger negotiations or other corporate developments which might account for unusual trading activity in its shares were materially false and misleading where the contacts between the company and a third party expressing a possible interest in merging with the company were preliminary in nature and had not reached the stage of an agreement in principle?
2. Did the Court of Appeals err, in an action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, in approving certification of a class of all persons who, during a fourteen-month period, sold shares of a company which had issued three allegedly false and misleading statements, by applying a presumption of reliance as a substitute for the requirement that each class member show that his decision to sell his shares was made in reliance on one of the statements?

PARTIES TO THE PROCEEDING AND RULE 28.1 LIST

The caption of the case in this Court contains the names of the parties to the proceeding except Mathew J. Ludwig, a former director of petitioner Basic Incorporated, who died on July 17, 1986, and is not a petitioner.

Petitioner Basic Incorporated is a wholly-owned subsidiary of Combustion Engineering, Inc. Combustion Engineering and its wholly-owned subsidiaries own a 20% or greater stock interest in the following domestic corporations:

Basic Ballistics Co.
Carmel Energy, Inc.
Cast Industrial Products Co.
Combustion Engineering/
Neyrpic Hydro Power, Inc.
C-E Delas-Weir, Inc.
C-E Hawaii, Inc.
C-E/MHI Fan Co.
C-E/Studsvik, Inc.
Hammol Dahl, Inc.
L.S. Transit Systems, Inc.
Project Funding Corp.
The Pryor Giggey Co.
Tennol Energy Co.
Tylinter Inc.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-279

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS, JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER, H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C. WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as trustee under the Karl Zuckerman Revocable Trust, and RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR PETITIONERS**OPINIONS BELOW**

The opinion of the United States Court of Appeals for the Sixth Circuit (App. 1a-20a)¹ is reported at 786 F.2d 741 (1986). The opinion of the Court of Appeals, as amended, denying a petition for rehearing and suggestion for rehearing en banc (App. 144a-146a) is not reported.

The opinion of the United States District Court for the Northern District of Ohio granting summary judgment to petitioners (App. 21a-112a) is unofficially reported in part at [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,801 (1984). The District Court's opinions conditionally certifying the class (App. 113a-127a) and denying reconsideration thereof

¹ References to "App." are to the Appendix submitted with the petition for a writ of certiorari (the "Petition"). References to "JA" are to the Joint Appendix submitted concurrently herewith.

(App. 128a-140a) and the order of the Sixth Circuit denying interlocutory review (App. 141a) are not reported.

JURISDICTION

The judgment of the Court of Appeals was entered on March 27, 1986 (App. 142a-143a). Rehearing was denied by an order dated June 19, 1986, as amended by an order dated July 2, 1986 (App. 144a-146a). By an order of this Court dated June 10, 1986, the time to file the Petition was extended to August 24, 1986 (App. 147a). The Petition was filed on August 23, 1986 and was granted by an order dated February 23, 1987. By an order dated March 4, 1987, petitioners' time to file this brief was extended to April 30, 1987. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

The statutes and rules involved in the proceeding are Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); the Rules Enabling Act, 28 U.S.C. § 2072; Rule 10b-5, 17 C.F.R. § 240.10b-5; and Rules 23 and 56, Fed. R. Civ. P. (App. 148a-150a; JA 8).

STATEMENT OF THE CASE

This class action, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, was commenced in June 1979 against petitioners Basic Incorporated ("Basic") and former members of its board of directors. Respondents based their claim on three public statements issued by Basic during a fourteen-month period preceding the December 1978 announcement of an agreement for the acquisition of Basic's shares by a subsidiary of Combustion Engineering, Inc. ("C-E"). Respondents alleged that those statements were false and misleading in failing to disclose that, between

October 1976 and December 1978, Basic and C-E were engaged in "continuous merger negotiations." Respondents further alleged that the issuance of those statements caused the price at which Basic shares traded on the New York Stock Exchange (the "NYSE") to be artificially depressed and that, as a result, respondents and members of the class were damaged when they sold their Basic shares.

In August 1984, the District Court granted petitioners' motion for summary judgment and dismissed this action in its entirety. In March 1986, the Court of Appeals reversed the District Court's grant of summary judgment and affirmed an earlier District Court order certifying this case as a class action.

A. The Facts

The pertinent undisputed facts, as developed during the course of extensive discovery, are as follows:

1. Events Prior To The Issuance Of The First Statement

Basic was primarily engaged in the manufacture and sale of refractories made from chemically basic materials. The refractories division of C-E ("C-E Refractories") was primarily a producer of alumina-based refractories and produced only an insignificant amount of basic refractories. (App. 22a).

C-E, which was interested in expanding its production of basic refractories, had held several informal meetings with Basic in 1965. (JA 81, App. 45a. n. 22). Nothing developed as a result of those meetings and, during the next ten years, Basic and C-E had only occasional contacts.²

In the fall of 1976, James B. Kelly, a C-E vice president in charge of its Industrial Products Group (the "IPG"), met with

² For example, Basic and C-E personnel sat on the board of the Refractories Institute, an industry trade organization. In addition, both companies conducted business in Canada and, at one time, they discussed the possibility of having C-E act as a sales representative in Canada for certain refractories products made by Basic. (JA 178a).

Max Muller, Basic's president, and discussed Kelly's interest in exploring the possibility of an acquisition of Basic by C-E.³ Muller told Kelly that Basic was not interested and preferred to remain independent. Although Basic was not for sale, Muller believed that he had an obligation to its shareholders to listen to Kelly or to anyone else with a similar interest. At Kelly's request, Muller met with him on other occasions during late 1976 and provided him with Basic sales data. (JA 86, 335-36, App. 45a).

Unbeknown to Basic, the IPG staff proposed in October 1976 that an acquisition of Basic for \$30 million be considered an IPG "initiative". (JA 337). In June 1977, senior C-E management withheld approval of that initiative. (JA 351-52, App. 46a-47a). And, in November 1976, Kelly made a presentation concerning Basic to the C-E executive committee. The committee, which was not asked to approve an acquisition of Basic, authorized Kelly to proceed with "investigations, preparations and, as appropriate, negotiations with respect to the possible acquisition of Basic." (JA 338, App. 46a).

At a meeting in January 1977, Kelly advised Muller and Mathew J. Ludwig, Basic's financial vice-president, that he remained interested in Basic but that C-E would not make an unfriendly tender offer. Kelly also suggested that Muller and Ludwig meet with C-E's president, but they refused to do so. (JA 345-46, App. 46a).

In September 1977, again unbeknown to Basic, the IPG staff renewed its proposal that an acquisition of Basic for \$30 million be considered an IPG "initiative". (JA 351). In January 1978, senior C-E management again withheld approval, noting that, "[b]ecause of Basic management's attitude," the possibility of an acquisition "does not appear to be an active area at present." (JA 366, App. 53a).

³ Kelly worked at the main C-E offices in Stamford, Connecticut. He made frequent visits to IPG operations in Cleveland, Ohio, where Basic had its main offices. Occasionally, in connection with those visits, Kelly would also visit Basic. (JA 277-78, App. 56a).

In October 1977, Kelly met with Muller, Ludwig and Anthony M. Caito, Basic's executive vice-president, and spoke generally about Basic and C-E. During that meeting, Kelly sketched a simple organization chart to show where a company such as Basic would fit in the C-E corporate structure if it were acquired. The Basic officials reconfirmed that Basic was not for sale, and no subsequent meeting was scheduled. (JA 113-14, 331-35, 358, App. 46a-47a, 53a-55a).⁴

On October 12, 1977, Muller, Ludwig and Caito met with representatives of Flintkote, Inc. ("Flintkote") to discuss a possible joint venture. On October 18, 1977, Muller received a telephone call from Flintkote informing him of a rumor that Flintkote was preparing a tender offer for Ideal Basic Inc.; although that company was not related to Basic, the rumor was interpreted as referring to Basic. At Muller's suggestion, a press release was drafted to dispel that unfounded rumor. In drafting that release, no one considered the sporadic contacts with Kelly. (JA 234, 359-62, App. 57a-61a).

2. Events Between The Issuance Of The First And Last Statements

On October 21, 1977, a Cleveland newspaper published the following article, based on this press release, containing the first statement of which respondents complain (JA 363, App. 5a, 59a):

BASIC INC. STOCK REACHED NEW HIGH IN HEAVY TRADING

Stock of Basic Inc. reached a new high of 20 5/8 yesterday on volume of 29,000 shares, closing at 20. It was as low as 15 but has been heavily traded lately, including 40,000 shares Oct. 7.

⁴ JA 331-35 is a handwritten chronology maintained by Muller concerning his contacts with Kelly. It was Muller's practice to maintain similar chronologies of contacts with other companies. See, e.g., JA 359-62.

President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of \$25 a share for control of the Cleveland-based maker of refractories for the steel industry.

As a result of the Flintkote rumor, Basic became concerned that it might become the target of a hostile tender offer. (JA 148, App. 66a-67a). In November 1977, Basic retained Kidder Peabody & Company, Inc. ("Kidder Peabody") to provide it with the investment banking services necessary to defend against such an offer. Basic also intended to seek assistance from Kidder Peabody in connection with any small acquisitions that it might wish to pursue. During that same month, Kelly spoke by telephone with Muller and asked—apparently in jest—whether Basic was ready to merge; Muller replied "not yet". (JA 234, 331, App. 67a).

In early 1978, Basic developed an interest in acquiring C-E Refractories, a part of the IPG. At a meeting in February 1978, Basic disclosed that interest to Kelly, who subsequently provided it with financial information concerning C-E Refractories. Basic discussed this information with Preston Insley, the controller of the IPG, at a meeting in March 1978 which Kelly did not attend. (JA 237). Basic anticipated that if a purchase of C-E Refractories were arranged, Basic would use its own shares as part of the purchase price. Thus, to enable C-E to value those shares, Basic provided Insley with information concerning its own refractories business. (JA 156, 160-61, 264, App. 70a-73a).

In June 1978, Basic told Kelly that it would offer \$26 million to acquire C-E Refractories. Kelly rejected the proposed price as too low. At the same time, he renewed his interest in the possibility of an acquisition of Basic by C-E and suggested \$28 per share. Basic immediately rejected this suggestion. Kelly then indicated that he would determine whether C-E would consider making an offer at a higher price. Basic discouraged

him from doing so. (JA 331-35, 382, App. 76a-78a). Later that month, when Muller telephoned to request additional information concerning C-E Refractories, Kelly proposed that counsel for Basic and C-E meet to consider the antitrust implications of any Basic and C-E combination. Muller did not agree to such a meeting and none was held. (App. 68a-71a, 86a n.51).

In July 1978, unbeknown to Basic, Kelly made another presentation concerning Basic to the C-E executive committee. As had been the case with the November 1976 presentation, the committee was not asked to and did not approve an acquisition; it again authorized Kelly only to continue his "investigations, preparations and, as appropriate, negotiations with respect to the possible acquisition of Basic." (JA 394-95).

In various telephone conversations with Muller during July 1978, Kelly (i) indicated that he would prepare an "informal offer" for Basic—Muller advised him that Basic would ask Kidder Peabody to appraise any such offer; (ii) requested Basic's earnings projections for use at a meeting between Kelly and C-E's investment banker, The First Boston Corporation ("First Boston"); (iii) inquired about the reason for certain unusual trading activity in Basic shares—Muller stated that Basic did not know the reason;⁵ and (iv) advised Muller that C-E and its counsel might consider contacting antitrust officials concerning a possible acquisition of Basic. Muller subsequently provided Kelly with projections and information relevant to a possible antitrust analysis. However, no "informal offer" or antitrust analysis was prepared, and no approach was made to antitrust officials. (JA 332-33, 387-88, App. 81a-88a).

Kelly and Muller had no further contacts between July 23, 1978 and late November 1978. Except for one telephone call made by Kelly on September 26, 1978, during which he asked

⁵ On July 14, 1978, Basic's shares rose 3 1/2 points to 26 7/8, its high for the year. When the NYSE telephoned to determine whether there were any corporate developments to account for that trading activity, Basic stated that there were none. The NYSE did not request that Basic issue any public statement and none was issued. (App. 107a-08a).

Ludwig about unusual trading activity in Basic's shares, Basic and C-E had no contacts of any kind for nearly four months. (JA 263, 273, 278-79, App. 6a-8a, 88a).

On September 25, 1978, during a period of unusual trading activity in its shares, Basic issued a press release at the request of the NYSE, which contained the second statement of which respondents complain (JA 400-01, App. 7a, 89a):

Basic Incorporated (NYSE:BAI) today reported that, although confident of the company's current and future business prospects, management is unaware of any present or pending company development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days.

Basic repeated the substance of that statement in its nine-month report to shareholders, dated November 6, 1978, which contained the final statement of which respondents complain (JA 403-05, App. 7a):

With regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months.

3. Events Following The Issuance Of The Last Statement

Three weeks later, on November 27, 1978, Kelly met with Basic for the first time since June 7, 1978. (JA 132-33, 279, 334, App. 88a). At that meeting, Kelly indicated that C-E might consider an acquisition of Basic for \$35 per share. Muller stated that any such offer would be too low. (JA 334, App. 33a-35a). Kelly's handwritten notes contain the following description of the meeting (JA 408-09):

I told them that we had not been back to them since the summer because . . . the relative low P/E of C-E stock made a stock for stock transaction unattractive to C-E.

An appropriate multiple for Basic over market price would result in dilution for C-E. I suggested that the concept of part cash (49% or less) and balance securities be considered.

* * *

In response to a price I suggested \$35. They didn't reject such a value but felt the price too low compared with market history over the last six months. They did not believe the market price high in relationship to their current earnings outlook of close to \$5 per share. They stated that they are not operating at high market level because of merger rumors. They thought the better market performance resulted from their good earnings performance and prospects and the recognition of the fact that their mineral reserves are substantially undervalued. They stated they had never heard any rumors about acquisition by C-E.

We left the meeting with an action program on their part which would be a review of whether cash or cash plus securities would be acceptable to them. If so, they would speak to Kidder Peabody for advice. A next step after that might be a meeting between Kidder Peabody and First Boston to see if the banks could agree on values.

Kelly had no further contact with Basic until December 14 when, following a meeting of the C-E executive committee at which—for the first time—Kelly was authorized to approach Basic with a formal proposal, Kelly telephoned Muller. Kelly requested a meeting on December 15 to discuss a possible acquisition. Muller was "shocked" and "not in favor of this approach." (JA 135-36, App. 39a). Muller, Ludwig and Caito immediately met with Kidder Peabody and discussed what Kelly had said. This was the first time that Kidder Peabody was informed that C-E was interested in acquiring Basic. (JA 296-99, App. 37a-38a).⁶

⁶ In July 1978, Basic had become concerned that the period of unusual trading activity described in n.5, *supra*, might indicate the commencement of a hostile tender offer and had advised Kidder

When Kelly telephoned Muller during the evening of December 14, Muller advised him that Basic would not meet with him the next day. (JA 135-36, App. 39a n.17). On Friday, December 15 (the last day of the class period), Basic agreed to meet with C-E, first on December 18 to discuss operating and related matters and then on December 19 to discuss the terms of any C-E proposal. (JA 137-38, App. 39a n.17).

During the weekend of December 16-17, Kidder Peabody and First Boston had a series of conversations concerning the price and structure of a proposal which C-E might be willing to make and which Basic might find acceptable. (JA 296-99, App. 40a-41a). Prior to the opening of trading on Monday, December 18, Basic advised the NYSE of its scheduled meeting with C-E, trading in Basic was suspended and Basic issued a press release announcing that it had been approached by a company "indicating an interest in acquiring" it. (App. 43a-44a).

At the meeting on December 18, Kelly discussed the manner in which C-E operated companies it acquired. (JA 335). On December 19, C-E's president and chief executive officer came to Cleveland and offered to purchase Basic shares for \$46 per share, amounting to over \$70 million for all the shares. That evening Kidder Peabody recommended that the Basic board of directors accept the C-E offer. The Basic board agreed and, on December 20, an agreement was signed and a public announcement was issued. (JA 414-16).

B. The District Court's Decisions

1. The Grant Of Class Certification

Respondents initially sought certification of a class of all sellers of Basic shares during the period between October 1976 and December 1978. They contended that the market price of Basic shares throughout that period had been artificially depressed by the three statements complained of and that all

Peabody that C-E might agree to act as a "white knight," should Basic need one. Prior to December 14, 1978, Kidder Peabody had not heard anything else to connect Basic and C-E. (JA 283a, App. 82a).

members of the putative class, as sellers on an open or impersonal market, were entitled to a presumption of reliance on the integrity of that market, even those who could not show that they had relied on any of the statements in reaching their decisions to sell.

Following respondents' withdrawal of the first year of the proposed class period, the District Court approved class certification for a fourteen-month period beginning October 21, 1977 and ending December 15, 1978. It explicitly noted that, absent the "fraud on the market" theory, it could not have done so. It recognized that, without a presumption of reliance, each class member would have to show actual reliance and that individual issues would predominate over issues common to the class within the meaning of Rule 23(b)(3), Fed. R. Civ. P. (App. 113a-127a).⁷

2. The Grant Of Summary Judgment

After extensive discovery,⁸ petitioners moved for summary judgment on the ground that, as a matter of law, none of the three statements at issue was (i) false or misleading, (ii) material, or (iii) wilfully or recklessly made. The District Court carefully analyzed the claims asserted and set forth the undisputed facts and controlling legal issues in a detailed and well-reasoned opinion. (App. 21a-112a). It concluded, within the meaning of Rule 56(c), Fed. R. Civ. P., that there was no

⁷ Following reconsideration, the District Court amended its order to exclude from the class persons who had purchased and then sold in the period between the issuance of the October 1977 and September 1978 statements and to permit interlocutory review under 28 U.S.C. § 1292(b). (App. 128a-140a). In April 1982, the Court of Appeals denied permission to appeal. (App. 141a).

⁸ See App. 26a. Respondents deposed members of Basic's management and board of directors, representatives of C-E and various third parties, including Basic's counsel and representatives of Kidder Peabody and First Boston. In addition, petitioners produced substantial documentary material, including transcripts and other materials developed during a lengthy SEC investigation—an investigation that did not result in the institution of any enforcement proceeding.

genuine issue as to any material fact and that petitioners were entitled to judgment as a matter of law.

The District Court held that the October 1977 statement was true because, despite the contacts between Basic and C-E prior to its issuance, there was no evidence that Basic was engaged in merger negotiations with C-E or with any other company. (App. 61a-62a).

It further held that, even viewing the contacts between Basic and C-E in June and July 1978 as preliminary merger discussions (App. 84a-85a), nothing had happened in the period between the last July contact and the issuance of the September and November 1978 statements to indicate that those discussions had continued. (App. 88a-100a). As a result, it held that those discussions could not "be legally characterized as negotiations which might imminently produce an agreement in principle" and, therefore, that statements to the effect that Basic was "unaware of any present or pending company development" to account for unusual trading activity in its shares could not, as a matter of law, be found to be false or misleading. (App. 100a-101a, 104a).⁹

Finally, the District Court held there was no genuine issue of fact as to whether petitioners had acted with scienter, either by intentionally or wilfully deceiving or defrauding investors or by recklessly issuing any of the statements at issue. (App. 110a-111a). Accordingly, in August 1984, the District Court granted summary judgment dismissing the action.

⁹ Contrary to the statement in the January 1987 Brief of the United States as Amicus Curiae (the "Gov't Brief") that the District Court had "ruled that Basic's second and third statements were false or misleading" (p. 3), the District Court in fact held that there was no genuine issue of material fact to support respondents' claim that the September 1978 statement was false and that, "[o]n the undisputed evidence it is determined as a matter of law that the public statement was true." (App. 99a). Similarly, it determined that the November 1978 statement was neither false nor misleading. (App. 104a).

C. The Court Of Appeals' Decision

1. The Reversal Of Summary Judgment

The Sixth Circuit rejected the District Court's findings and conclusions and reversed its grant of summary judgment. It held that the failure to disclose the contacts between Basic and C-E rendered Basic's statements inaccurate and that information as to those undisclosed contacts was made material by the issuance of the statements. It did not consider whether the contacts between Basic and C-E had progressed to a point where there was an agreement in principle on the fundamental terms of a merger or whether there was a reasonable likelihood that a merger would occur. According to the Court below, if a company issues a statement which denies an unfounded rumor or any corporate developments to account for unusual trading activity in its shares (hereafter a "no corporate developments statement"),¹⁰ its failure to describe events, no matter how remote or speculative, that might in the future lead to a significant transaction renders its statement materially misleading.¹¹

The Court recognized that its decision was in conflict with *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985), which held, as a matter of law, that until an agreement in principle had been reached on terms fundamental to a merger (e.g., price and structure), a no corporate developments statement is not materially misleading even if preliminary merger contacts had occurred. (App. 13a).

¹⁰ A public company usually issues a no corporate developments statement in response to an inquiry from the exchange on which its shares are listed seeking an explanation of rumors concerning the company or unusual trading activity in its shares. See, e.g., New York Stock Exchange Listed Company Manual § 202.03, "Dealing With Rumors or Unusual Market Activity." (JA 535-36).

¹¹ Finally, the Court of Appeals also vacated the District Court's ruling as to scienter: "Because summary judgment is generally inappropriate for issues of scienter, knowledge and intent . . . this issue must be first decided by the district court and may not be decided by us as a matter of law." App. 16a. In so doing, it ignored the District Court's holding that there was no basis in the record to support a finding of scienter. (App. 110a-111a).

2. The Affirmance Of Class Certification

The Sixth Circuit affirmed the District Court's class certification order. (App. 16a-20a). After noting that the District Court had "found the [predominance] requirement of Rule 23(b)(3) problematic," it approved the application of a presumption of reliance based on the fraud on the market theory "[t]o circumvent what the district court perceived to be a barrier to class actions in 10b-5 cases." (App. 16a).

SUMMARY OF ARGUMENT

The decision below applied a view of the materiality requirement of Rule 10b-5 which vastly extends the application of the Rule and which, as this Court and others have recognized, may accomplish more harm than good for the investors whom the Rule is designed to benefit. The effect of the Sixth Circuit's erroneous view of materiality is compounded by the virtual elimination of the predominance requirement of Rule 23(b)(3) by application of a presumption of reliance to support class certification in this sellers' case.

The record fully supports the conclusion of the District Court that none of Basic's statements was false, materially misleading or improperly motivated. The District Court's conclusion was based on a detailed review of the evidence and a practical analysis of the materiality requirement consistent with the standards applied in similar cases by other lower courts.

As to the first statement, the District Court found that the sporadic contacts between Basic and C-E as of October 1977 were of the most preliminary kind. Basic was merely a passive listener, had taken no steps to encourage Kelly to pursue his interest and had made no internal preparations to respond to him. Accordingly, the District Court determined that the statement was true.

As to the second statement, the District Court found that, while the contacts between Basic and C-E in June and July 1978 might be considered "preliminary merger negotiations,"

they could not be regarded as negotiations which might imminently produce an agreement in principle. When the second statement was issued in late September 1978, there had been no contact between Basic and C-E for two months. In addition, there was no reason to believe that the June and July contacts were in any way related to the unusual trading activity in late September 1978. As a result, the District Court found the second statement to be neither false nor materially misleading.

As to the third statement, which merely repeated Basic's lack of knowledge of the reasons for the September trading activity, the District Court noted that Basic had heard nothing from C-E for more than three months and held that that statement was neither false nor materially misleading.

By contrast, the Court of Appeals substituted a rule of materiality lacking any rational basis that it applied to a mistaken view of the record. The Court acknowledged that "an initial duty to disclose material merger negotiations exists only in certain limited circumstances" (App. 9a), such as where a company trades in its own stock or where it is responsible for rumors leaking into the market. There is no claim that any such circumstances existed here. According to the Court, however, information regarding the discussions between Basic and C-E became material "*by virtue of the statement denying their existence.*" (App. 13a, emphasis in original). The District Court's reading of Basic's statements as true was rejected as unduly narrow, and the statements were held to be material on the ground that a "reasonable investor" would regard every contact with a third party regarding a possible merger—no matter how remote, tentative or preliminary—as a "significant corporate development".

The position adopted below distorts the purpose of Section 10(b) by requiring disclosure of the most insignificant and inconclusive contacts. This is more confusing than helpful to investors and could deprive them of the important advantages of many mergers. Discussions such as occurred here should not be viewed as material or required to be disclosed, even when a no corporate developments statement is issued, unless an

agreement in principle on the fundamental merger terms of price and structure has been reached. Moreover, those discussions were not material even under the "probability/magnitude" standard proposed by the Government because a merger was not probable when any of the statements was issued.

Distortion of Section 10(b) was furthered by application by both courts below of a presumption of reliance derived from the "fraud on the market" theory which effectively eliminates the requirement of reliance as a basic element of a private action under Rule 10b-5. As a result of that theory, the right to proceed by class action is superimposed on the judicially-created private action implied from Rule 10b-5.

Presumptions are created to eliminate the need of proof where there is a high probability of a connection between a known fact and that which is presumed. They rest on considerations of policy which justify relaxing the burden of proof on the party for whose benefit the presumption is created. Application of the presumption of reliance to this sellers' case cannot be justified either by the probability of the assumption on which it rests or by the policy of expanding class actions, as to which this Court has expressed its serious misgivings. And, by modifying the substantive rights of the parties, the presumption violates the Rules Enabling Act, 28 U.S.C. § 2072.

ARGUMENT

I. THE DISTRICT COURT'S GRANT OF SUMMARY JUDGMENT SHOULD HAVE BEEN AFFIRMED

The Court of Appeals' reversal of the District Court's grant of summary judgment was based upon an incorrect formulation of the legal standard of materiality governing this case and a distorted view of the record.

A. The General Standard Of Materiality

Under the standard of materiality formulated in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), information is material only if there is

. . . a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.¹²

In *TSC*, this Court explicitly rejected a standard of materiality under which any information that a reasonable investor "might consider important" would be deemed material. 426 U.S. at 446 (emphasis in original). Quoting *Gerstle v. Gamble-Skogmo*, 478 F.2d 1281, 1302 (2d Cir. 1973), it "agree[d] with Judge Friendly, speaking for the Court of Appeals in *Gerstle*, that the 'might' formulation is 'too suggestive of mere possibility, however unlikely.' " 426 U.S. at 449.

As stated in *TSC* (426 U.S. at 448-49):

Some information is of such dubious significance that insistence on its disclosure may accomplish more harm

¹² Although *TSC* involved the materiality under the proxy rules of information relevant to shareholder approval of a proposed acquisition, its standard of materiality has uniformly been applied in actions under Section 10(b) and Rule 10b-5.

than good. The potential liability . . . can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision-making.

B. The Materiality Of Preliminary Merger Discussions Should Not Be Presumed Because A No Corporate Developments Statement Is Issued

According to the decision below, companies issuing statements denying knowledge of corporate developments which might account for unusual trading activity must disclose every contact relating to a possible merger in order to avoid exposure to liability. Under this standard, issuance of such statements makes material any discussions to which they conceivably could refer:

When a company whose stock is publicly traded makes a statement, as Basic did, that "no negotiations" are underway, and that the corporation knows of "no reason for the stock's activity," and that "management is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity," information concerning ongoing acquisition discussions becomes material *by virtue of the statement denying their existence.*

* * *

. . . In analyzing whether information regarding merger discussions is material such that it must be affirmatively disclosed to avoid a violation of Rule 10b-5, the discussions and their progress are the primary considerations. However, once a statement is made denying the existence of any discussions, even discussions that might not have been material in the absence of the denial are material

because they make the statement made untrue. (App. 12a-13a, 14a-15a) (emphasis in original).

As a result, the materiality requirement of Rule 10b-5 merges into the separate requirement that the statement be false or misleading, effectively eliminating materiality as a discrete element of a claim for relief.¹³

In the view of the Sixth Circuit, upon the issuance of a no corporate developments statement, any undisclosed preliminary merger contacts become material even if the contacts were insignificant or stale, the company had no reason to believe that any unusual trading activity in its shares was connected to the contacts, and no one with access to undisclosed information concerning the contacts had sought to exploit that information.

The Sixth Circuit described the relevant events as if indeterminate contacts between Basic and C-E occurring sporadically during a fourteen-month period necessarily reflected a progression toward a preordained outcome. Its indifference to the factual record is shown by its failure to distinguish among the three statements at issue¹⁴ or to analyze the contacts between Basic and C-E to determine whether, immediately prior to the time that any statement was issued, they had advanced to a

¹³ The Government has noted that "[r]ead literally the opinion below states that a company's false denial of merger discussions is material solely because it is untrue. . . . This equating of falsehood and materiality has no basis under *Northway*, and would appear to render any false statement, regardless of how trivial, per se material." Gov't Brief, pp. 13-14.

¹⁴ Although the Court below repeatedly referred to "denials of merger negotiations," in fact only the October 1977 statement, issued to deny rumors relating to Flintkote, referred to merger negotiations. (See, e.g., App. 2a, 10a, 11a, 13a, 14a). Both the September and November 1978 statements referred to the absence of a "present or pending company development" to "explain" or "account for" unusual trading activity; they made no reference to merger negotiations. To the Court below, however, "[a] statement that 'no negotiations' were occurring could reasonably be read to state that no contacts of any kind whatsoever regarding merger had occurred." (App. 11a) (emphasis in original). That is simply a distortion of ordinary English usage.

point at which, objectively viewed, a merger was probable.¹⁵ It thus ignored the distinction made in *TSC* between information which *would* assume actual significance to a reasonable shareholder and information which *might* assume such significance. Its standard would require disclosure of any contact—no matter how tentative, inconclusive or stale—whenever a no corporate developments statement is issued. That is neither good law nor desirable business practice.

C. Preliminary Merger Discussions Are Not Material Unless An Agreement In Principle Has Been Reached

As previously noted (n. 10, *supra*), companies responding to stock exchange inquiries concerning unusual trading activity typically disclose information which accounts for that activity or, if they lack such information, issue no corporate developments statements. Yet it is decidedly in the interest of companies and investors that transactions requiring confidentiality not be jeopardized by premature disclosure. This is not to deny that, as the Court below stated, there is a duty to speak the truth when a statement is made. But during a period of preliminary discussions, the boundaries of that duty depends upon the applicable standard of materiality.

In *Greenfield v. Heublein, Inc.*, *supra*, the Third Circuit formulated a standard of materiality which properly focused on the significance of preliminary merger discussions at the time a no corporate developments statement is issued. In affirming summary judgment for defendants, it held that such a statement was not materially misleading because, at the time of its issuance, the company (Heublein) and its friendly suitor

¹⁵ Nor did the Court below evaluate the accuracy of the statements in light of the information known to Basic. It did not explain how internal developments at C-E that were not communicated to Basic could have any relevance to a determination of the materiality of Basic's statements. See, *infra*, pp. 32-33. Indeed, the Court largely based its analysis of the accuracy of Basic's statements—and hence, in its view, the materiality of the underlying contacts—upon these internal developments at C-E. For example, as to the October 1977 statement, it stated that "[b]ecause of the 'Strategic Plan' of Comus regarding Basic, had there been only one telephone call from Kelly to Muller, this statement would have been clearly untrue." (App. 11a).

(Reynolds) had not reached an agreement in principle on terms fundamental to a possible merger, such as price and structure.

In *Greenfield*, Heublein had received a series of unacceptable demands from a third party attempting a hostile takeover. It thereafter met with Reynolds. Five days later, following unusual trading activity in its shares and an inquiry from the NYSE, Heublein issued a no corporate developments statement. Twelve days later, its investment bankers and those of Reynolds met for the first time to discuss the price and structure of a merger. Two days later, a merger was announced.¹⁶

In analyzing Heublein's duty to disclose its contacts with Reynolds at the time it issued the statement, the Third Circuit stated (742 F.2d at 756-57):

Merger discussions arise in a wide variety of circumstances and the standard used to determine when disclosure of these is required must be both flexible and specific. . . . [T]he possibility of substantial liability for tardy disclosure, would likely result in corporations issuing early public statements announcing the details of all merger talks. Not only would this have a disruptive effect on the stock markets, but, considering the delicate nature of most merger discussions, might seriously inhibit such acquisitive ventures.

Under the facts of the present case, it was more appropriate for the court below to determine that an agreement in principle to merge had been reached when the parties reached agreement on "price and structure." Although it is difficult to draw a bright line definition that will apply to all cases, these two factors are typically critical aspects of any merger. Agreement as to price and structure provides concrete evidence of a mature understanding

¹⁶ The two-week period between the issuance of the statement and the merger agreement in *Greenfield* is in striking contrast to the lengthy periods—fourteen months, three months and more than one month, respectively—that separate the statements issued by Basic from the announcement of its agreement with C-E.

between the negotiating corporations. They constitute a usable and definite measure for determining when disclosures need be made. Finally, with both price and structure agreed to, there is only a minimal chance that a public announcement would quash the deal or that the investing public would be misled as to likely corporate activity.

In basing the determination of the materiality of preliminary merger discussions upon the existence of an agreement in principle, *Greenfield* provides clear guidance as to whether a no corporate developments statement may properly be issued by a company engaged in preliminary merger discussions.

The *Greenfield* rationale is consistent with several Court of Appeals decisions, issued following this Court's decision in *TSC*, rejecting claims of wrongdoing based upon a failure to disclose preliminary merger discussions. For example, in *Staffin v. Greenberg*, 672 F.2d 1196, 1207 (3d Cir. 1982), the Third Circuit held that a company's failure to disclose preliminary merger discussions did not render documents soliciting a tender of shares materially misleading. In affirming summary judgment for defendants in a class action by persons who had tendered, *Staffin* referred to the fact that numerous courts had "concluded that it is not necessary to disclose, in connection with a purchase or sale of securities, the occurrences of preliminary merger discussions." 672 F.2d at 1205. See also, cases cited in App. 30a n. 9.

Staffin emphasized the wisdom of withholding disclosure of such contacts until an agreement in principle has been reached (672 F.2d at 1207):

Those persons who would buy stock on the basis of the occurrence of preliminary merger discussions preceding a merger which never occurs, are left "holding the bag" on a stock whose value was inflated purely by an inchoate hope. If the announcement is withheld until an agreement in principle on a merger is reached, the greatest good for the greatest number results. If the merger occurs, all of the company's shareholders usually benefit; if no merger

agreement is reached, the stock performs as it would have in any event.

Similarly, in *Reiss v. Pan American World Airways*, 711 F.2d 11 (2d Cir. 1983), an announcement for a call of debentures did not disclose that, on the same day, the company had resumed negotiations for a merger which, one week later, was agreed to and publicly announced. In affirming summary judgment for defendants in a class action by persons who tendered their debentures prior to that announcement, the Second Circuit held that the company had no duty to disclose its merger discussions because no agreement in principle had been reached. It recognized that merger "negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned." 711 F.2d at 14.

The agreement in principle standard was applied most recently in *Flamm v. Eberstadt*, [Current] Fed. Sec. L. Rep. ¶ 93,178 (7th Cir. 1987), where a company issued public statements opposing a hostile tender offer which failed to disclose its discussions with a possible "white knight". The Seventh Circuit held that those discussions were not material because there had been no agreement in principle on price and structure. It explained the dangers of premature disclosure of preliminary merger discussions as follows (p. 95,803):

Some potential acquirers may demand that negotiations proceed in secrecy. They may fear that premature disclosure may spark competition that will deprive them of part of the value of their effort, so that bids in a world of early disclosure will be lower than bids in a world of deferred disclosure. One specter facing any potential buyer is the winner's curse—the prospect that the high bidder wins the auction only because he alone has placed an unrealistically high value on the assets. Negotiations in the glare of publicity may lead putative buyers to think that whenever they locate a bargain they will be preempted by some other bidder who waits in the wings, but whenever they offer too much they will be left with their "prize". The

heads-I-win-tails-you-lose quality of this process will lead either to a general reduction in offers (to assure that no offer is too high) or to a refusal to offer the best price without being assured of victory. Either way, silence during negotiations may be beneficial for investors.

The Seventh Circuit in *Flamm* concluded that the *Greenfield* standard best accomplishes the dual purposes of avoiding premature disclosure and providing certainty as to when disclosure is required. It stated (p. 95,804):

[S]ilence pending settlement of the price and structure of a deal is beneficial to most investors, most of the time. We do not think that the securities laws war against the best interests of investors. Rule 10b-5 is about *fraud*, after all, and it is not fraudulent to conduct business in a way that makes investors better off—that all investors prefer *ex ante* and that most prefer even *ex post*.

* * *

We agree, too, with the conclusion of the other circuits that the benefits of certainty supply additional support for the price-and-structure rule. If disclosure must occur at an earlier date, how much earlier? That would be fertile ground for disputation. No matter how soon the firm announced the negotiations, investors could say that it should have done so a little sooner. The pressure to advance the date of disclosure by “just a little” (at a time) would erode the benefits of deferral. No rule other than a clear one would have staying power. The time at which information should be disclosed ought to be readily ascertainable. The price-and-structure rule will leave some questions in doubt, but it is better than any alternative. (emphasis in original).

Most expressions of interest in a possible acquisition never materialize into an actual merger. Disclosure of preliminary merger discussions without regard to whether they are likely to result in a merger may inhibit negotiations that, if successful, could benefit investors, and may increase the risk that investors will be misled into believing that a merger is imminent when, in

fact, it is not. The agreement in principle standard applied in *Greenfield* balances a company's interest in avoiding premature and disruptive disclosure of merger contacts and the investment community's interest in all information concerning that company, whether material or not. It also provides a precise rule to guide corporate management in determining when disclosure must be made.

Considerations present in other cases where preliminary merger negotiations have been held to be material are not present here. Those cases all involved special circumstances that were regarded as imposing a duty to disclose any information relating to possible mergers or sales of the companies involved. Thus, where insiders or their tippees purchase a company's stock with knowledge that the company is seriously considering the possibility of a merger, the fact that the company's preliminary merger discussions or plans have not ripened into an agreement in principle does not preclude a finding of their materiality. This is so whether the insiders make their purchases in the impersonal market¹⁷ or from a shareholder in a close corporation.¹⁸

¹⁷ See, e.g., *Securities and Exchange Comm. v. Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976) (corporate insider tipped information concerning a firm plan to merge to third parties who traded thereon) and *Securities and Exchange Comm. v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974) (merger brokers traded on the basis of information concerning a merger they were negotiating). See, also *Rothberg v. Rosenbloom*, 771 F.2d 818, 821 (3d Cir. 1985) (“The best proof of the materiality of [nondisclosed] information is that the [defendants], themselves experienced investors, found it to be sufficiently material . . . to purchase . . . stock when it was depressed in price.”).

¹⁸ See, e.g., *Michaels v. Michaels*, 767 F.2d 1185 (7th Cir. 1985), cert. denied, ___ U.S. ___, 106 S. Ct. 797 (1986) (defendants purchased stock from their nephew); *Holmes v. Bateson*, 583 F.2d 542 (1st Cir. 1978) (defendants purchased stock from the widow of their deceased partner without disclosing ongoing negotiations for a merger subsequently consummated at a higher price); *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir.), cert. denied, 439 U.S. 970 (1978) (defendants purchased plaintiff's stock without disclosing, in response to plaintiff's specific question, a plan to sell the company); *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975) (defendant purchased a partner's stock

The imposition of a duty to disclose, with an attendant lower standard of materiality, is warranted in such cases in order to ensure the disgorgement of unfair gain by those who exploit undisclosed information for their personal profit. But there is no such justification for rejecting the agreement in principle standard and applying a lower threshold of materiality to claims such as those asserted here. Petitioners did not engage in insider trading or otherwise facilitate the improper use of undisclosed information by communicating it to third parties who traded thereon, and they should not be treated as if they had.

D. The "Probability/Magnitude" Standard Proposed By The Government Is Less Satisfactory Than The *Greenfield* Standard

Because of a concern that the *Greenfield* standard might permit unscrupulous insiders to take "advantage of uninformed shareholders by trading without making any disclosure of the negotiations," the Government has characterized that standard as erroneous. (Gov't Brief, p. 13).¹⁹ The Government's concern is misplaced. As shown above, the courts consistently apply a lower standard of materiality to ensure that insiders trading on undisclosed information are properly sanctioned for their misdeeds.

Although the *Greenfield* standard does not immunize insider trading and has the distinct benefit of specifying the point at which information about merger negotiations should be

without disclosing a plan to sell the company); and *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974) (defendant purchased a partner's stock without disclosing a plan to sell the company and ongoing negotiations for the sale).

¹⁹ The SEC also criticized *Greenfield* in *In re Carnation Co.*, SEC Exch. Act Rel. No. 22214, 33 SEC Docket p. 874, 877 n. 8 [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (July 8, 1985). There, in response to accurate rumors concerning its negotiations with Nestle, Carnation falsely denied that such negotiations were in progress. *Carnation* involved a false statement and not one characterized as misleading in creating an impression that something was not happening when, in fact, it was.

disclosed, the Government has advanced a "probability/magnitude" standard as the proper gauge of materiality (Gov't Br., pp. 8-9, 15). Where the shareholders of a company are bought out in a merger, as here, the Government's standard would have materiality hinge on a determination that, on the basis of all of the facts known at the time that a no corporate developments statement was issued, a merger was probable.

This standard ignores the practical impossibility of predicting whether, many years later in a litigation setting, a finder of fact would conclude that a merger was probable at the time a statement was issued. It thus provides no clear guide to corporate management as to when disclosure must be made while at the same time promoting premature disclosure which might be inimical to investors. This standard encourages "no comment" responses, which the SEC has approved (*Carnation*, *supra*, 33 SEC Docket at 877 n.6), but which, as pointed out in *Flamm*, *supra* p. 95,805, are an unsatisfactory resolution of the problem.

. . . if the firm says "no comment" that is the same thing as saying "yes" because investors will deduce the truth. No corporation follows the CIA's policy of saying no comment to every inquiry; every firm regularly confirms or denies rumors, as the securities laws and the stock exchanges' rules require. The exchanges' rules require a response, not a refusal to respond to inquiries. When a firm suddenly says "no comment," the inquisitor will realize that his suspicions have a foundation—yet the response may sow confusion all the same. (emphasis in original)

The *Greenfield* standard, on the other hand, avoids these pitfalls. While a no corporate developments statement does not assure the market that all is quiet on the corporate front, it does make clear that the company issuing the statement has not reached an agreement in principle with any prospective merger candidate. Buyers and sellers thus are left in the same position they were in prior to the issuance of the statement and their subsequent trading decisions will be made, as they should be,

on the basis of their individual appraisals of the company's future.

E. The Standard Of Materiality Applied By The District Court Is Consistent With The Government's "Probability/Magnitude" Standard

Even if the Court adopts the Government's "probability/magnitude" standard, the conclusion as to petitioners' entitlement to summary judgment should be no different than under the *Greenfield* standard. The legal standard applied by the District Court is essentially identical to the Government's proposed standard and the undisputed facts in the record make clear that the "probability" issue should be resolved in favor of petitioners as a matter of law.

The District Court premised its analysis on the view that, in order to be material, the contacts between Basic and C-E should reflect "negotiations destined, with reasonable certainty, to become a merger agreement in principle between Combustion and Basic." (App. 103a). It stated that once a company issues a public statement about a material corporate event, it has a duty to make the statement complete enough so as not to be misleading. (App. 27a-28a). It correctly recognized that the record contained no indication that petitioners had sought in any way to benefit from undisclosed information as to Basic's contacts with C-E. As a result, it properly distinguished cases involving insider trading or other allegations of corporate wrongdoing. (App. 27a).

In the District Court's view, before discussions become material, there must be evidence of bargaining on the terms of a proposed merger. It commented on the lack of any bargaining between Basic and C-E on such terms (*see, e.g.*, App. 35a, 61a), noting that, for example, their investment bankers had never even spoken until after the third statement had been issued. (App. 38a). Similarly, prior to that statement, no one had ever received authorization to make an offer to Basic on behalf of C-E. (App. 35a-36a, 100a-01a). After a detailed examination of the record, it found no evidence to indicate that there was an attempt to discuss, in substantive detail, price

and terms, or any other "negotiations which might imminently produce an agreement in principle." (App. 100a).

Accordingly, the District Court determined that, when Basic's statements were issued, the contacts between Basic and C-E had not progressed to a point where a merger was "reasonably certain" so that they should be disclosed. (App. 101a). This conclusion is the equivalent of a determination under the Government's proposed standard that, as a matter of law, there is no basis for holding that a merger was probable.

F. Under Any Proper Standard Of Materiality The Grant Of Summary Judgment To Petitioners Should Have Been Affirmed By The Court Of Appeals

Under both the agreement in principle and the "probability/magnitude" standards of materiality, the contacts between Basic and C-E were not material as a matter of law.²⁰ Under these circumstances, there can be no "sufficient disagreement to require submission to a jury"; the evidence "is so one-sided that [petitioners] must prevail as a matter of law." *Anderson v. Liberty Lobby, Inc.*, ___ U.S. ___, 106 S. Ct. 2505, 2512 (1986).

Viewing the record and all inferences therefrom in a light most favorable to respondents, the District Court carefully analyzed the undisputed facts and determined that petitioners had met their "burden of showing *conclusively* that there exists no genuine issue as to a material fact." (App. 25a). It reviewed every contact between Basic and C-E and determined that at no point could they be "legally characterized as negotiations which might imminently produce an agreement in principle." (App. 100a).

²⁰ Although the District Court did not apply the agreement in principle standard, its decision is clearly correct under that approach. The Court of Appeals acknowledged that the contacts between Basic and C-E would not be material under the *Greenfield* rationale. (App. 13a).

The District Court's findings should have been accorded deference by the Court below. *Lois Sportswear U.S.A., Inc. v. Levi Strauss & Co.*, 799 F.2d 867, 873 (2d Cir. 1986) (when a Court of Appeals reviews a grant of summary judgment, "the district court's detailed findings . . . are entitled to considerable deference"). Cf., *Anderson v. Bessemer City*, 470 U.S. 564, 574-75 (1985), in which this Court stated that a District Court's findings of fact made following a bench trial, including those based upon "documentary evidence or inferences from other facts" not implicating credibility determinations, should not be reversed unless clearly erroneous:

The trial judge's major role is the determination of fact, and with experience in fulfilling that role comes expertise. Duplication of the trial judge's efforts in the court of appeals would very likely contribute only negligibly to the accuracy of fact determination at a huge cost in diversion of judicial resources. In addition, the parties to a case on appeal have already been forced to concentrate their energies and resources on persuading the trial judge that their account of the facts is the correct one; requiring them to persuade three more judges at the appellate level is requiring too much.

This objective of judicial economy is equally important on review of district courts' dispositions of motions for summary judgment.²¹

The present case offers a graphic example of a waste of judicial resources. Even though the District Court had carefully reviewed the record and considered the relevant docu-

²¹ See the Final Report of the Second Circuit Committee on the Pretrial Phase of Civil Litigation (June 1986) at 18, recommending that the Second Circuit

adopt as a standard, and announce, that in reviewing summary judgments it gives due deference to the district courts appraisal of the record. Even though the "clearly erroneous" limitation written into Rule 52 does not literally apply to appellate review of determinations by the district court of Rule 56 motions, a similar principle of deference should restrain the Court of Appeals. Dicta in the Supreme Court's recent decision in *Anderson v. City of Bessemer*, 105 S.Ct. 1504 (1985), suggest the appropriateness of such an approach.

ments and testimony as to each contact between Basic and C-E, as well as various matters unrelated to those contacts, the Court of Appeals barely discussed the District Court's decision. Instead, without citation to the record, it set forth a fanciful description of what it labeled the "factual background" (App. 2a). That description is unsupported by the record, wholly at odds with the findings of the District Court and, simply stated, one which makes no practical sense. The Court of Appeals apparently had formed the impression that, throughout the fourteen-month class period, Basic and C-E were engaged in continuous high-level discussions and had extensive contacts with their investment bankers for the purpose of consummating a merger. But it provided no explanation as to why, if this were so, it took so long to reach an agreement.

This Court has recently ruled that a party opposing a motion for summary judgment "must do more than show that there is some metaphysical doubt as to the material facts. . . . The non-moving party must come forward with 'specific facts showing that there is a *genuine issue for trial*.'" *Matsushita Electric Industrial Co., Ltd. v. Zenith Radio Corp.*, ____ U.S. ____, 106 S. Ct. 1348, 1356 (1986) (emphasis in original). Where, as here, "the factual context renders respondents' claim implausible . . . respondents must come forward with more persuasive evidence to support their claim than would otherwise be necessary." *Id.* In light of the reality of the merger process and the sequence of events in this case, it is simply not plausible that two companies actively negotiating for a merger would take years to achieve their goal. The Court of Appeals' description of the record in a manner suggesting the presence of active negotiations is unavailing.

1. As to the contacts between Basic and C-E

The Court of Appeals stated that "[b]etween September, 1976, and October, 1977, Kelly made numerous telephone contacts as well as trips from Combustion's Connecticut offices to Basic's Cleveland offices." (App. 4a). The record shows that during this period, which was prior to the com-

mencement of the class period, there were four meetings, three telephone calls and one letter (*supra*, pp. 3-5) and that, in any event, many of the meetings occurred simply because Kelly was visiting the IPG's Cleveland operations. (JA 277-78, App. 56a).

The Court of Appeals asserted, without citation to the record, that during these "numerous" contacts, Basic and Kelly discussed how C-E "operated companies like Basic after acquisition", and that C-E "would consider Basic an independent unit after acquisition." (App. 4a). The only possible support for these assertions is Kelly's description of the sketch he drew of the IPG structure during the October 1977 meeting. (JA 113-14, 358). But, as the District Court found (App. 54a-55a), even if "[t]he undisputed evidence including reasonable inferences would permit a finding that Kelly indicated where Basic would fit in the Industrial Products Group of Combustion if Basic were ever acquired . . . , there is no evidence that Basic indicated a desire to be acquired by C-E or that C-E would acquire Basic."

The Court of Appeals failed to mention that, between January and July 1978, Basic's contacts with C-E arose from its independent interest in acquiring C-E Refractories. The "[c]onfidential information including financial forecasts and projections" (App. 5a) exchanged during that period was relevant to the possibility of that distinct and, indeed, inconsistent acquisition. (App. 66a-78a).

Finally, the Court of Appeals referred to the continuation of contacts between the September 1978 and November 1978 statements (App. 7a). With the exception of one telephone conversation the day after the second statement was issued (*supra*, pp. 7-8), there were no contacts of any kind. (App. 102a).

2. As to internal developments at C-E

Much of the "factual background" set forth by the Court of Appeals relates to internal developments at C-E of which Basic was unaware. In referring to the October 1976 and September 1977 proposed initiatives of the IPG as including the acquisi-

tion of Basic for \$30 million (App. 3a, 5a), it ignored the fact that no basis exists to impute knowledge of those proposed initiatives to Basic. But unless Basic had such knowledge, these plans may not fairly be viewed as relevant to an evaluation of the materiality of Basic's discussions with C-E. The significance of this oversight is heightened by the Court's disregard of the fact that both proposed initiatives were rejected by C-E's corporate staff "[b]ecause of Basic management's attitude," which made clear that a possible acquisition did "not appear to be an active area at present." (App. 46a-47a, 52a-53a).

The Court of Appeals referred to the preparation by First Boston of "analyses of acquisition prices" of Basic (App. 4a, 6a) without explaining how these analyses, which First Boston's merger and acquisition specialist characterized as mere "number pushing exercises" (JA 290-91), could have any significance. Moreover, First Boston did not contribute anything of significance until after the last statement was issued because its "first team" did not even become involved until then. (JA 134). In any event, Basic never was informed of the "analyses of acquisition prices" prepared by First Boston. (JA 401-02).

3. As to internal developments at Basic

The Court of Appeals stated that "[i]n August, 1977, and on October 18, 1977, Basic's management met with Basic's investment bankers, Kidder Peabody, to discuss preparation of a valuation of Basic for use in the merger negotiations." (App. 5a). Kidder Peabody was retained "to assist [Basic] in a general financial advisory capacity and also with specific reference to the possibility of their being an acquisition target." (JA 283). In fact, Basic did not request and Kidder Peabody did not make any "valuation of Basic for use in the merger negotiations" until after the final statement was issued. (JA 283). In short, Basic received no advice or valuation from Kidder Peabody relevant to a possible merger with C-E until the close of the class period. (JA 152, 283a).

Thus, the Court of Appeals' "factual background" is a collection of unconnected, insignificant and inaccurate minutiae assembled in a way to support the speculative contention that petitioners misled the investment community by denying the existence of negotiations for a merger which allegedly had been a principal corporate goal for years. This scenario is contradicted by the contemporaneous documentary record of the events in issue and the extensive testimony elicited in discovery in this action and during the SEC investigation. It defies logic and plausibility.

The uncontradicted factual record, as set forth in the decision of the District Court, shows that the award of summary judgment to petitioners should have been affirmed by the Court of Appeals.

II. THE COURTS BELOW IMPROPERLY CERTIFIED THE CASE AS A CLASS ACTION BY APPLICATION OF A PRESUMPTION OF RELIANCE

The courts below recognized that respondents had the burden of proving their entitlement to a class action, as well as the elements of a fraud action—falsity, materiality, reliance, causation and scienter. They permitted this case to be pursued as a class action by relieving respondents of their burden of proving the essential element of reliance. This was done by applying the so-called fraud on the market theory, which the District Court characterized as

... a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of Rule 23. To require proof of individualized reliance in every 10(b)(5) misrepresentation action would bar such actions from proceeding as class suits because the individual questions would far outnumber and overwhelm the common ones. (App. 118a).²²

²² For class certification to be appropriate under Rule 23(b)(3), a court must find, among other things, that "the questions of law or fact

The Court of Appeals described the theory as based on two assumptions: first, in an efficient market the price of a security reflects all information available to investors; and second, investors rely on the integrity of the market price when trading in that security. (App. 17a).

Under this theory, courts have adopted a presumption of reliance by which traders in a security on an efficient market are deemed to have acted in reliance on the integrity of the market and thus indirectly on the specific misrepresentations or omissions which are assumed to have affected the price of the security. In putative class actions, this presumption is applied to justify certification of a class broad enough to include persons with no awareness of the available information.

The presumption of reliance finds no support in any decision of this Court or in any statute or rule. It radically alters the implied right of action under Rule 10b-5 and abridges the substantive rights of defendants in contravention of the Rules Enabling Act. Further, the present case is particularly inappropriate for the application of such a presumption. It is simply unreasonable to assume that widely-separated statements denying merger negotiations or disclaiming knowledge of corporate developments to account for unusual trading activity would have a continuing impact on the price at which Basic shares were traded.

A. Application Of A Presumption Of Reliance To Facilitate Class Certification

The purported foundation of the fraud on the market theory is a decision of this Court in a case which did not involve either a transaction on an impersonal securities market or class certification. In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), fiduciaries responsible for protecting the rights of shareholder beneficiaries purchased securities directly

common to the members of the class predominate over any questions affecting only individual members."

from their beneficiaries without disclosing that the securities were worth substantially more than the amount paid. This Court rejected the fiduciaries' contention that the beneficiaries had to show actual reliance upon the failure to disclose the material information as to the securities' value. 406 U.S. at 153.

The *Affiliated Ute* decision is premised on the difficulty of proving reliance where there is a failure of required disclosure, a difficulty not present where there is a misrepresentation. See, e.g., *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 93 (2d Cir. 1981), quoting *Titan Group Inc. v. Faggen*, 513 F.2d 234, 238-39 (2d Cir.), cert. denied, 423 U.S. 840 (1975):

"[*Affiliated Ute*], rather than abolishing reliance as a prerequisite to recovery, was recognizing the frequent difficulty in proving, as a practical matter, that the alleged misrepresentation, allegedly relied upon, caused the injury. . . . Unlike instances of affirmative misrepresentation where it can be demonstrated that the injured party relied upon affirmative statements, in instances of total non-disclosure, as in *Affiliated Ute*, it is of course impossible to demonstrate reliance". . . . What is important is to understand the rationale for a presumption of causation in fact in *Affiliated Ute*, in which no positive statements exist: reliance as a practical matter is impossible to prove. . . . The situation here does not present that problem. (emphasis in original).

Despite the fact that its rationale applies only in nondisclosure cases, lower courts have interpreted *Affiliated Ute* as providing a basis for dispensing with the reliance requirement in Rule 10b-5 cases where purchasers of securities allege that materially misleading statements wrongfully inflated the price paid by them. The leading case on the certification of a class of purchasers, on which both courts below relied, is *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).

Plaintiffs there claimed that defendants had misrepresented the financial condition of their company by not disclosing a \$90 million loss in numerous public statements issued throughout a two-year period with the result that the price of securities purchased by plaintiffs on the impersonal market had been artificially inflated. The Court held that a class member could establish that he was caused to engage in the transaction at issue "by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance." 524 F.2d at 906. Accordingly, *Blackie* facilitated class certification by applying a rebuttable presumption which, in its view, eliminated reliance as an individual issue otherwise predominating over other common issues.²³

Blackie's broad presumption has been extended to facilitate class certification even when it is acknowledged that putative class members were unaware of, or indifferent to, the statements upon which their claims are based. See, e.g., *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), cert. denied, 465 U.S. 1026 (1984) (class certification granted in action alleging wrongful issuance of bonds, even though not all members of the putative class had received the allegedly misleading documents and, therefore, could not have relied upon them); cf., *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985) (refusing to dismiss class action complaint in which plaintiffs conceded that, while they did not rely directly on misleading documents which caused the market price to be artificially inflated, they "detrimentally relied upon the integrity of the market prices in purchasing the securities").

²³ Although the Court in *Blackie* described its presumption as rebuttable, it acknowledged that the right to rebut would be largely illusory (524 F.2d at 906-7 n. 22):

We doubt the right to disprove causation will substantially reduce a defendant's liability in the open market fraud context, as we doubt that a defendant would be able to prove in many instances to a jury's satisfaction that a plaintiff was indifferent to a material fraud.

B. Application Of A Presumption Of Reliance Cannot Be Reconciled With This Court's Decisions Limiting Private Actions Under Rule 10b-5

The Court in *Blackie* (524 F.2d at 908) read *Affiliated Ute* as "a rejection of the burden [of proving reliance] because it leads to underinclusive recoveries and thereby threatens the enforcement of the securities laws". Its application of a presumption of reliance reflects a policy of ensuring the liberal availability of class action status for claims arising under the federal securities laws. Indeed, as the Court below conceded, a court may "circumvent" what "it perceived to be a barrier to class actions in 10b-5 cases," by applying "a presumption of reliance so that common questions predominated." (App. 16a).

The rationale of *Blackie* is irreconcilable with later decisions of this Court under Rule 10b-5 in two ways. First, those decisions have expressed the Court's concern, not about underinclusive recoveries, but with the vast over-extension of recoveries. Secondly, the reference to the "enforcement of the securities laws" begs the question. The issue presented by the fraud on the market theory is the scope of one of those laws, Rule 10b-5, in the context of a private damage action. In both respects, the theory cannot be reconciled with this Court's decisions. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); cf., *Santa Fe Industries v. Green*, 430 U.S. 462 (1977) and *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 476 (1978) ("Certification of a large class may so increase the defendant's potential damages liability and litigation costs that he may find it economically prudent to settle and to abandon a meritorious defense.").

In *Blue Chip*, this Court expressed reservations both with judicial expansion of the class of plaintiffs permitted to prosecute Rule 10b-5 claims and with the unwarranted extension of the nexus between a defendant's fraud and all subsequent transactions involving the underlying securities. It stated (421 U.S. at 747, 748-49):

While much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good.

* * *

. . . as we have pointed out, we are not dealing here with any private right created by the express language of § 10(b) or of Rule 10b-5. No language in either of those provisions speaks at all to the contours of a private cause of action for their violation. . . . We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question.

Likewise, in *Hochfelder*, in rejecting the SEC's contention that Rule 10b-5 should be held applicable to a misrepresentation made without scienter, this Court stressed that the private action under the Rule had not been created by Congress and should be narrowly circumscribed.

C. Application Of A Presumption Of Reliance To Facilitate Class Certification Violates The Rules Enabling Act

In addition, in contravention of the Rules Enabling Act, 28 U.S.C. § 2072,²⁴ the use of a presumption of reliance improperly abridges the substantive rights of defendants in actions under Rule 10b-5 and concomitantly enlarges the substantive rights of plaintiffs through the use of a procedural rule. In individual actions, defendants pursue discovery directed to plaintiffs' claimed reliance and in many cases establish that there was none, thereby enabling them to succeed on a motion for summary judgment or, at a minimum, to negotiate a rea-

²⁴ The Rules Enabling Act, 28 U.S.C. § 2072, provides, as relevant here, that the Federal Rules of Civil Procedure "shall not abridge, enlarge or modify any substantive right."

sonable settlement. Where the presumption of reliance is used to facilitate class certification, these rights are lost.

The benefit of the presumption is secured by a naked allegation that defendants' misconduct affected the integrity of the impersonal market and that a significant number of investors relied thereon in reaching trading decisions. Yet, because pretrial discovery of putative class members is generally limited,²⁵ defendants will be unable to develop facts to show that few investors relied upon the alleged misconduct and that such reliance had little effect upon the market price. Only after liability is established and proofs of claim are submitted by putative class members seeking to participate in a recovery can attempts be made to pursue discovery in this regard. The theoretical right to discovery following an adjudication on the merits does not undo the damage to defendants' right to seek summary judgment or a fair settlement in advance of a trial.

As a result, claims of investors which could not withstand scrutiny if prosecuted individually would survive through trial—simply by virtue of class certification. This has a dramatic effect on the settlement and trial strategy of defendants—substantive rights which are lost forever.

Further, in a misguided attempt to avoid a violation of the Rules Enabling Act arising from the application of different reliance requirements in individual and class actions, courts have stated that the presumption of reliance may be applied in individual actions as well. See, e.g., *Blackie*, 524 F.2d at 908:

Defendants contend that elimination of individual proof of subjective reliance alters and abridges their substantive rights in violation of the Rules Enabling Act, 28 U.S.C. § 2072. The obvious answer is that the standards of proof of causation we have set out apply to all fraud on the market cases, individual as well as class actions. No interpretation of Rule 23 is involved, and the Rules Enabling Act limitation is not implicated.

²⁵ See, e.g., *Brennan v. Midwestern United Life Ins. Co.*, 450 F.2d 999, 1005 (7th Cir. 1971), cert. denied, 405 U.S. 921 (1972).

There is no basis for applying a presumption of reliance in individual misrepresentation actions which do not present the inherent problems of proof upon which *Affiliated Ute* is premised. See, e.g., *Wilson v. Comtech Communications Corp.*, *supra*, and *Chelsea Associates v. Rapanos*, 527 F.2d 1266, 1271 (6th Cir. 1975) (distinguishing nondisclosure cases and noting that proof of reliance is required in misrepresentation actions). Yet that is precisely what must be done to avoid violating the Rules Enabling Act. This distortion of substantive law to facilitate the use of a procedural device cannot be what Congress intended when it adopted the Rules Enabling Act, and it should be rejected.

The courts have transformed the *Affiliated Ute* presumption of reliance on the omissions of a fiduciary into a presumption of reliance in Rule 10b-5 actions generally; and then have expanded this presumption from an allocation of the burden of proof, as in *Affiliated Ute*, into a gloss on Rule 23(b)(3), itself a creation of the courts, not Congress. Thus, although Section 10(b) did not expressly provide for a private damage action, through the linkage of judicially-created rules, in which a presumption of reliance plays a major role, private class actions may now be maintained as a matter of course for virtually every Rule 10b-5 claim. This is a wholly unwarranted expansion of the securities laws unjustified either by precedent or policy.

D. There Is No Logical Basis For Application Of A Presumption Of Reliance In This Case

Even if this Court were to find that the presumption of reliance should not be confined to situations involving difficulties of proof, that it is not inconsistent with Congress' intent in enacting the Securities Exchange Act and that it does not violate the Rules Enabling Act, the presumption should not be applied in this case.

Presumptions are based on two factors: the probability of the connection between the known fact and that which is presumed to exist and the policy which they serve. When

presumptions are mechanically applied in disregard of probability and desirable policy, they have no justification. In *Pan-duit Corp. v. Allstate Plastic Mfg. Co.*, 744 F.2d 1564, 1581 (Fed. Cir. 1984), the Court wrote:

Presumptions of fact have been created to assist in certain circumstances where direct proof of a matter is for one reason or another rendered difficult. They arise out of considerations of fairness, public policy, and probability, and are useful devices for allocating the burden of production of evidence between the parties. However, derived as they are from considerations of fairness and policy, they must not be given mechanical application We must not give undue dignity to a procedural tool and fail to recognize the realities of the particular situation at hand.

Here, the application of the fraud on the market theory would require the assumption that the statements issued by Basic had a depressing effect on the market price of its securities which continued during the fourteen-month class period. The speculative and irrational nature of this necessary assumption is best illustrated by contrasting the likely market impact of disclosure of the information, the nondisclosure of which caused the numerous documents issued in *Blackie* to be materially misleading, with the disclosure of the information which respondents contend rendered Basic's statements materially misleading.

It may be reasonable to assume that disclosure of the \$90 million loss in *Blackie* would have caused an immediate, dramatic and continuing impact on the prices at which the company's securities traded on the impersonal market. It is not likely that the impact of the disclosure of a loss of that magnitude on the market performance of the company's shares would be mitigated by other developments affecting the company. On the other hand, even if it were assumed that the impact of a series of disclosures of each contact by Kelly with Basic and each reaction by Basic to Kelly's interest might cause occasional changes in the market price of Basic shares for short

periods of time, it could not reasonably be assumed that the impact of any of those disclosures would survive throughout the fourteen-month class period. Instead, it is likely that the market soon would become indifferent to each new report of a Kelly visit to Cleveland.

In short, the differences between a company's \$90 million loss and a company's sporadic contacts with a friendly suitor are substantial. As a result, the likely market impact from the issuance of statements which fail to disclose the loss or the contacts could not reasonably be assumed to be comparable. Thus, the fraud on the market theory, if it has vitality, should not be applied in a case such as this.

Further, even if decisions to purchase securities, as in *Blackie*, rationally could be presumed to have been made on a relatively common basis influenced primarily by the market price of the security, there is no corresponding justification for an assumption regarding decisions to sell, especially over a long period of time.²⁶ Decisions to sell are likely to be highly individualized, reflecting the financial condition and investment requirements of each seller more than the market price of the stock. For example, an individual's decision to sell may arise from a desire to use the proceeds to purchase stock in a different company or from personal tax considerations. In-

²⁶ Significantly, no other Court of Appeals has considered the propriety of certifying a class of sellers in an action under Section 10(b) and each of the District Court decisions certifying a sellers' class involved a short class period. Thus, *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535 (S.D.N.Y. 1982), the only case cited by the Court below (App. 18a) in which a class of sellers was certified, involved a class period of only eight days. The District Court there apparently believed that it could reasonably be assumed that those who sold during such a short period might have been commonly influenced by a no corporate developments statement in reaching their decisions to sell.

In other cases in which district courts have certified a sellers' class, defendants did not oppose such certification. See *Friedlander v. Barnes*, 104 F.R.D. 417 (S.D.N.Y. 1984) (two-week class period) and *Staffin v. Greenberg*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,385 (E.D. Pa. 1980) (ten-week class period).

deed, individuals frequently sell solely to make funds available for other purposes.

There is simply no basis to accord a presumption of reliance to facilitate class certification of actions by sellers involving lengthy class periods and claims based upon indeterminate events.

CONCLUSION

For the foregoing reasons, the decision of the United States Court of Appeals for the Sixth Circuit should be reversed.

Dated: New York, New York
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RESPONDENT'S

BRIEF

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL
EELLS, JR., JOHN A. GELBACH, HARLEY C. LEE, MAX
MULLER, H. CHAPMAN ROSE, EDMUND Q. SYLVESTER
AND JOHN C. WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust, and RONALD
M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

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Questions Presented

1. In an action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1981), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1986), in which petitioners had issued repeated public statements that there were no ongoing merger negotiations and that they were aware of no significant corporate developments which would account for the unusual trading activity in the stock of Basic Incorporated ("Basic") at the very time that petitioners were, in fact, pursuing active merger discussions with Combustion Engineering, Inc., did the Court of Appeals err in holding that summary judgment was improper under Rule 56 of the Federal Rules of Civil Procedure to determine (a) whether petitioners' public statements were false or misleading and (b) whether petitioners' ongoing merger discussions were material to a "reasonable investor"?
2. Did the Court of Appeals err in affirming the District Court's grant of class certification on behalf of those persons who sold shares of Basic during the period following petitioners' issuance of the false and misleading public statements and in applying the fraud on the market doctrine?

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IN THE
Supreme Court of the United States

October Term, 1986

No. 86-279

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER AND JOHN
C. WILSON, JR.,

Petitioners,

—V.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and
as trustee under the Karl Zuckerman Revocable Trust,
and RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENTS

Statement of the Case

This action is brought as a class action pursuant to Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b) (1981), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1986). The complaint alleges that Basic Incorporated ("Basic") issued a series of public statements in which it falsely represented and suggested to the investment community that no merger discussions were underway when, in fact, Basic was involved in active merger discussions with Combustion Engineering, Inc. ("Combustion"). In the first public statement, Basic flatly denied that it was engaged in negotiations with any other company for a merger. In the second and third public

statements, Basic denied that there were "any significant corporate developments" which would account for the activity in the stock. Each of the public statements was issued for the very purpose of dispelling rumors in the marketplace that Basic was involved in ongoing merger discussions. The latter two statements were issued in the specific form prescribed by the New York Stock Exchange only for situations in which there are no merger discussions underway and the rumors of merger discussions are, in fact, false.

The District Court granted summary judgment dismissing the complaint because of its view that there was not any triable issue of fact as to the materiality of the ongoing merger discussions between Basic and Combustion to the reasonable investor.

The Sixth Circuit reversed, holding that the materiality of the merger negotiations, and hence the determination whether the three public statements were either false or misleading, were properly questions for the trier of fact. The Sixth Circuit held that there were more than sufficient facts upon which a jury could, and in all likelihood would, consider Basic's ongoing merger discussions to be significant to the reasonable investor. The Sixth Circuit also affirmed the District Court's grant of class certification.

A. The Facts

The pertinent facts as developed during discovery are as follows:¹

1. The Basic-Combustion Merger Discussions Prior to October, 1977

Prior to December 20, 1978, Basic was a public company engaged, among other things, in the manufacture of refrac-

¹ References to "JA" are to the Joint Appendix. References to "App." are to the Appendix submitted with the Petition for a Writ

(footnote continued on following page)

tories. (R. 137, Ex. 8) Basic's securities were traded on the New York Stock Exchange. (R. 137, Ex. 111) Basic's offices were located in Cleveland, Ohio. The three principal officers of Basic were Max Muller ("Muller"), Basic's Chairman and Chief Executive Officer; Matthew J. Ludwig ("Ludwig"), Basic's Senior Vice-President; and Anthony M. Caito, Basic's Executive Vice-President. (R. 137, Ex. 199)

Combustion was a publicly-traded company having its principal offices in Connecticut. (JA 66) Combustion's shares were traded on the New York Stock Exchange. (R. 137, Ex. 31) As of December, 1978, Combustion had assets of more than \$1.6 billion and was engaged in a variety of businesses, including the manufacture and sale of refractories. (*Id.*) While Basic manufactured only chemically basic refractories, Combustion manufactured only alumina or acid-based refractories. (R. 137, Ex. 8)

James Kelly ("Kelly") was the Vice-President in charge of Combustion's Industrial Products Group; Arthur Santry ("Santry") was the Chairman and Chief Executive Officer of Combustion; and Lambert Gross ("Gross") was Combustion's Financial Vice-President. (R. 137, Ex. 31)

Because of the complementary nature of Basic's and Combustion's businesses, Combustion first became interested in acquiring Basic in 1965 or 1966. (JA 81-3) In 1966, Kelly and Santry met with Ludwig, Muller and certain of Basic's shareholders, but because Combustion expected antitrust problems, merger discussions were not pursued further at that time. (JA 81-3, 108, 225-26)

In 1976, the FTC commenced a proceeding (the "Kaiser-Lavino proceeding") in which the FTC took the

(footnote continued from preceding page)

of Certiorari. References to "R" are to the Record. References to exhibits are to the exhibits submitted to the District Court, all of which are included in R. 137.

position that basic and alumina (or acidic) refractories were two separate markets. (JA 82-3) Because of the *Kaiser-Lavino* proceeding, Combustion determined that the antitrust obstacles to a merger had been removed, and Combustion decided to pursue active merger negotiations with Basic. (JA 82-3, 225-26) Thus, the 1977-1983 "Strategic Plan" of Combustion's Industrial Products Group, dated October 25, 1976, stated in pertinent part:

"Initiatives

The following table lists the major initiatives which have been identified and will be implemented by IPG [Industrial Products Group] during the planning period along with an estimate of the capital requirements for each.

[Material redacted by Combustion]

Acquire Basic Inc. \$30 million." (R. 137, Ex. 7, p. 2, JA 337)

In about September, 1976, Kelly telephoned Muller to arrange a meeting with Basic's management to discuss a possible merger. (JA 81-4) Between September and December, 1976, Kelly made several trips from Connecticut to Basic's offices in Cleveland. (R. 137, Ex. 86) On those visits, Kelly, Muller and Ludwig discussed Combustion's interest in acquiring Basic, "how we [Combustion] operated companies like Basic after acquisition," and where Basic would fit in Combustion's corporate structure following an acquisition of Basic by Combustion. (JA 125-26)

Based upon the complementary nature of Basic's and Combustion's businesses, Muller agreed that a combination of the two companies should be pursued. (JA 227). Thus, Muller testified:

"A. To the best of my recollection I agreed that the two refractory businesses would be complementary.

Q. And did you agree that some form of combination might be desirable? A. To the best of my recollection I agreed.

Q. Then that's why you entered into these discussions? Are you nodding yes? A. Yes." (JA 227)

Accordingly, Basic's management decided to actively pursue discussions with Combustion for a merger.

In October, 1976, Kelly asked Combustion's lawyers to conduct an antitrust investigation for the acquisition. (JA 84-7) At Kelly's request, Muller provided Kelly with confidential, non-public information relating to Basic's sales and operations. (R. 137, Ex. 6; JA 84-7, 227, 335-36)

On November 18, 1976, Kelly and Santry called a special meeting of the Executive Committee of Combustion's Board of Directors to discuss the acquisition of Basic. In his presentation, Kelly emphasized that the only way for Combustion to be an effective competitor in the refractories industry was to acquire Basic. Following Kelly's presentation and "extensive discussion of the material presented," Kelly was authorized to "continue to proceed" with his investigations, preparations, and negotiations to acquire Basic. (JA 87-9, 109-10, 338-41)

Having received the approval of their Executive Committee, Combustion's management informed their investment bankers, First Boston Corporation ("First Boston"), of their desire to acquire Basic, and asked Joseph Perella, one of the heads of First Boston's merger and acquisitions department, to prepare an analysis of the acquisition. (R. 137, Exs. 3, 4; JA 286-88) At Combustion's request, First Boston prepared analyses for the acquisition of Basic at prices of \$18, \$20, and \$22 per share, or premiums of about 22% to 44% over the existing market price of Basic's stock. (*Id.*)

In January, 1977, Muller circulated to Basic's Board of Directors a memorandum, entitled "Recent Interest in Basic," in which he informed the Board of the meetings with Combustion's management, Combustion's antitrust study for the acquisition of Basic, and an upcoming meeting with Kelly scheduled for January 12. Muller wrote:

"September-December 1976:

COMBUSTION ENGINEERING

Several visits by Jim Kelly, V.P. of industrial division. CE lawyers anticipate no opposition from 'antitrust', since CE is not now in 'Basic' products. Jim Kelly will visit Cleveland at 9:30 Jan. 12." (R. 137, Ex. 130)

On January 10, two days before Muller's meeting with Kelly, Muller and Ludwig spoke with H. Chapman Rose, a director and outside counsel for Basic. Muller, Rose, and Ludwig discussed "Basic as a merger target" and the "present list of 'suitors'" for Basic. Muller asked Rose for "legal guidance on management's obligations and responsibilities" upon receiving an offer for the company. (JA 342) Rose's diary for January 10 stated:

"Long tel. con. Muller re various merger proposals and legal requirements relating thereto." (R. 137, Exs. 225, 226)

On January 12, 1977, Kelly met with Muller and Ludwig at Basic's offices in Cleveland. As stated in Kelly's summary of the meeting,

"[Kelly] opened the meeting by stating that CE is very interested in Basic, Inc. as an acquisition in order to be in a position to compete with H&W, A.P. Green, General & Kaiser. We are handicapped at present by not being in the basic refractories market and being unable to enter the market from scratch as a possible alternative to acquisition.

Muller and Ludwig agreed that without the acquisition of Basic Inc. we [Combustion] could not be an overall competitor of H&W, A.P. Green, General & Kaiser." (JA 345-46)

Kelly further advised Muller and Ludwig

"that a presentation had been made to the executive committee of our [Combustion's] Board of Directors and that the Committee has reviewed the facts presented and authorized continued negotiations looking toward acquisition." (*Id.*)

Kelly assured Muller that Combustion would consider Basic "an independent unit and would respect its management and modus operandi" following the acquisition, and that Combustion "could offer an acquisition package that was attractive to the stockholders and met the needs of the employees in keeping Basic, Inc., competitive and viable in the basic refractories business. . . ." (JA 227-31, 345-46)

Muller reported on his discussions with Kelly at the Basic Board meeting immediately following the January 12 meeting, and again at the May 20, 1977 meeting. (JA 231; R. 137, Exs. 131A, 147) Between February and May, Kelly and Muller spoke by telephone, and they arranged a further meeting to be held in July. (R. 137, Exs. 131A, 147) According to Rose's diary, on April 20 a meeting was held among Rose and several other Basic attorneys "on possible bid by Combustion." (R. 137, Exs. 225, 226)

At the Basic Directors meeting on May 20, Muller again reported on Basic's discussions with Combustion, and he distributed an updated "Recent Interest in Basic" memorandum in which he stated:

"COMBUSTION ENGINEERING

Several Visits by Jim Kelly, V.P. of industrial division. CE lawyers anticipate no opposition from 'Anti-trust'. CE is not now in 'Basic' products. Jim

Kelly visited Cleveland at 9:30 Jan 12 reaffirming CE's interest in Basic. JK called MM on Feb. 17. JK called on May 10. MM may visit JK in July." (R. 137, Exs. 131A, 147)

In June, 1977, Kelly learned that Combustion's outside counsel, Shearman & Sterling, had been approached by another company, Steetley, to acquire Basic. (JA-352) Because of their concern about the possibility of an offer from some company other than Combustion, Kelly and Muller decided to accelerate their next meeting. On June 16, Muller telephoned Kelly to arrange a meeting among Kelly, Muller, Caito and Ludwig for June 24. (*Id.*)

On June 24, Kelly met with Muller, Ludwig and Caito in Cleveland to discuss the possible merger with Combustion. (R. 137, Exs. 14, 50) Kelly, Muller and Ludwig all testified that they did not recall what was discussed. (JA 231, 144-45, 110) However, on June 28, only four days later, Muller telephoned John Wilson, a director of Basic, and Muller told Wilson he expected Combustion to make a "merger offer for Basic." (R. 137, Ex. 129; JA 324-26, 244-45)² On June 30, Rose once again met with Muller and Caito. (R. 137, Ex. 93) Rose's diary

² Wilson's notes of the conversation state:

"Max ph 6/28/77
Combustion Engig [Engineering]
ladle black Jim Kelly
alumina brick VP 500,000,000
friendly interest
merger offer for Basic
conflict interest
[material redacted by Basic]

U.S. Gypsum

Thurs. Chap Rose

joint venture Fla
10-20% partic Basic shares
Cleve Gentlemen—buy substantial bloc
Basic on market—Chappie" (R. 137,
Ex. 129; JA 324-26, 244-45)

for June 30 succinctly stated, "Messrs. Muller, Caito and Ludwig re merger offers." (R. 137, Exs. 225, 226)³

In June, 1977, Ludwig directed Theodore Thomas, the Treasurer of Basic, to prepare an analysis, entitled "Basic and Combustion Engineering: Relative Values," to assist Muller, Ludwig and Rose in evaluating a merger with Combustion. (R. 137, Exs. 99, 151A; JA 353-57, 256) In his cover memorandum forwarding the analysis to Rose, Ludwig wrote:

"HCR

Herewith the C-E 1976 Annual Report and the analysis we usually make in considering mergers or acquisitions which I promised.

MJL

7/1/77" (JA 353-57)⁴

Similarly, following Kelly's meeting with Muller and Ludwig, in June and July, 1977, Combustion prepared detailed analyses of various alternatives for the acquisition of Basic at premiums of 25-50% over the existing market price of Basic stock. (R. 137, Exs. 24, 25; JA 112-113)

In August, 1977, Basic approached Kidder, Peabody & Company, Inc. ("Kidder, Peabody") to discuss the employment of Kidder, Peabody as Basic's investment adviser and the preparation of a valuation of Basic for use in the merger negotiations. (JA 235, 241-42, 250) Basic's management met with Kidder, Peabody in August, 1977, and again on October 18, 1977, only two days before Muller's delivery of the first of the three public denials to *The Cleve-*

³ Similarly, the diary entry of one of Basic's outside attorneys for July 1 stated: "Attent to possible tender offer." (R. 137, Ex. 225)

⁴ Basic prepared similar "Relative Value" analyses for Basic and Combustion in August, 1976 (R. 137, Ex. 98), June, 1977 (R. 137, Exs. 99, 151A), March, 1978 (R. 137, Ex. 100), some time after September 30, 1978 (R. 137, Ex. 102), and December, 1978 (R. 137, Exs. 101 and 103).

land Plain Dealer. (R. 137, Parker Exs. 2, 4) As Muller testified, the explicit purpose of the meetings was to employ Kidder, Peabody to render a valuation of Basic and to determine an acceptable merger price for the company. (JA 250)

In its "Strategic Plan" for 1978-1984, dated September 23, 1977, Combustion's Industrial Products Group reaffirmed its commitment to acquiring Basic. (JA 350) Accordingly, Kelly and Muller arranged to meet again on October 12. (R. 137, Exs. H, 94) On October 11, Ludwig, Muller and Caito met to prepare for their meeting with Kelly the next day. (*Id.*)

On October 12—only one week before the October 21, 1977 public statement and just prior to discussions with Kidder, Peabody about preparing the valuation of Basic—Kelly met with Muller, Ludwig and Caito at Basic's offices in Cleveland. (JA 331)⁵ At that meeting, Kelly, Muller, Ludwig and Caito discussed the role that Basic would have in Combustion's corporate structure following Combustion's acquisition of Basic, and Kelly drew Muller, Ludwig and Caito a chart to show "the Basic people how they would fit into the Combustion organization." (JA 113-14, 358)⁶

Throughout 1977 and 1978, there were widespread rumors in the investment community that Basic was involved in merger discussions, as the result of which there were repeated bouts of unusual trading activity in Basic stock. During those periods, Basic received up to 15 calls a day from brokers and stockholders asking if there were ongoing merger discussions. (JA 312, 317-23) On October 19-20,

⁵ JA 331-35 (R. 137, Ex. 20D) is a "memory crutch" prepared by Muller summarizing some of his meetings and communications with Kelly.

⁶ In their depositions, Muller, Ludwig and Kelly all claimed that they did not recall what was discussed at the October 12 meeting, beyond the role that Basic would have within the Combustion corporate structure. (JA 113-14, 231-32, 146-47)

1977, following the October 12 meeting with Combustion, and the day after the October 18 meeting with Kidder, Peabody, rumors of merger discussions caused the daily trading volume in Basic stock to soar from an average of 6,000-8,000 shares per day to more than 29,000 shares per day. (R. 137, Ex. 68)

For the specific purpose of quieting the trading activity in Basic stock and putting the rumors of merger activity to rest, on October 20, 1977, Muller issued a statement to the press, published in the October 21, 1977 issue of *The Cleveland Plain Dealer*, in which he stated that:

"the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger." (JA 363) (emphasis added)

2. The Basic-Combustion Merger Discussions Between October, 1977, and December, 1978

On November 9, 1977, Ludwig, Thomas, and one of Basic's attorneys met with Martin Siegel, who was then the head of Kidder, Peabody's merger and acquisitions department and Geoffrey Parker, another Kidder, Peabody merger and acquisition specialist. (JA 364-65; R. 137, Parker Ex. 4)⁷ In November, Basic retained Kidder, Peabody in order to prepare a valuation of Basic's securities and, according to Muller, to determine an "acceptable merger price figure for Basic." (JA 250, 241)⁸ Thus, Lambert Gross, Combustion's Financial Vice-President, informed First Boston:

"Basic hired Kidder, Peabody because 3 largest sh [shareholders] want to sell—tax free." (JA 383, 288-89)

⁷ Basic retained Kidder, Peabody with a verbal retainer which was subsequently confirmed in writing. (JA 241, R. 137, Parker Exs. 8, 10)

⁸ Muller testified that in the initial discussions with Kidder, Peabody, Basic's management did not identify Combustion as a suitor by name because of the concern of Basic's management for the confidentiality of the merger discussions. (JA 239)

On October 27, 1977, Kelly telephoned Muller to advise him of a rumor that Hepworth Corporation, an English company, was planning to make a tender offer for Basic. (JA 331) On November 10, Muller telephoned Kelly and confirmed to Kelly that Hepworth was, in fact, interested in acquiring Basic. (*Id.*) According to Muller's notes, Kelly then asked "Are you ready to merge with Basic [sic]?" Because Muller felt that further preparations were required, including the valuation of Basic from Kidder, Peabody, Muller responded "not yet." (JA 331, 248-50) (emphasis added).

Following the November 10 conversation, meetings were held between Kidder, Peabody personnel and Basic management to collect information concerning Basic's operations and to prepare the valuation of Basic's shares which Basic had requested. (R. 137, Parker Exs. 7, 12, 13, 14, 17, 23)

On February 6, 1978, Muller telephoned Kelly to arrange a meeting. (JA 331) In accordance with his practice of keeping Kelly advised of the merger approaches of other companies—even though that was confidential, non-public information—Muller advised Kelly of an impending visit by two senior officers of Hepworth to discuss Hepworth's interest in acquiring Basic, whereupon Kelly and Muller agreed to meet on February 27. (JA 331)

On February 27, Kelly, Muller and Ludwig met in Cleveland. (JA 331) Muller and Ludwig agreed to assist Combustion in preparing a detailed study of Basic's operations to assist Combustion in valuing Basic's business, and to provide Combustion with confidential, non-public sales and earnings projections. Kelly, Muller and Ludwig arranged for Preston Insley, Combustion's Comptroller, to meet with Basic's management on March 13 to collect the financial information concerning Basic's operations. (JA 67-81, 165-66)

On March 1 and 2, meetings were held at Basic among Muller, Ludwig, Thomas and Edward P. Arnolt, Basic's Comptroller, to discuss the information concerning Basic's operations to be collected for Combustion. (JA 163-74) Between February and March, Arnolt prepared financial statements and extensive studies to be given to Insley, including confidential financial statements and projections for all of Basic's divisions. (R. 137, Exs. 44, 104, 105; JA 68-81, 168, 171-84) On March 10, Muller, Ludwig, Caito and Arnolt met to review Arnolt's analyses. As succinctly stated in Muller's summary of the meeting:

"Decision: proceed with meeting CE-Basic—as was planned for 3-13-78" (JA 331)

On March 22, Insley met with Ludwig, Arnolt, Thomas and Muller. (JA 331-32) Basic gave Insley confidential, non-public earnings projections for 1978-80 and the financial studies of Basic prepared by Arnolt. (JA 331-32, 68-70, 171-72) Muller testified that he also gave Kelly confidential earnings projections to assist Combustion in preparing an offer for Basic:

"Q. You gave them this forecast to assist them in preparing this offer?

A. Yes." (JA 271)

Following the March 22 meeting, Kelly instructed Insley to prepare a detailed analysis of Basic's operations for a meeting to be held with Muller, Ludwig and Caito on June 7. (JA 68-81) On March 27, April 3, and April 4, Muller met with Ludwig, Caito, Thomas and Arnolt to discuss the financial analyses of Basic prepared for Combustion. (JA 332; R. 137, Ex. 249; JA 483, 485)

Between March and May, 1978, Insley and another officer of Combustion worked on analyses of Basic's operations and the acquisition of Basic for use at the meeting with Basic on June 7. (JA 70-81; R. 137, Exs. 15, 39, 44, 45, 106, 107.)

In preparation for the June 7 meeting, Basic's management also prepared analyses to determine a fair price for Basic. (R. 137, Exs. 90, 90A; JA 152-55)

On April 4, Muller again spoke with Wilson about the ongoing merger discussions. Muller told Wilson that he expected Combustion to make an offer to acquire Basic at \$25 to \$30 per share, or some 25-50% above the existing market price of Basic stock. (R. 137, Ex. 132) At Basic's Directors meetings on April 11 and May 26, 1978, Muller again updated the Board on the status of Basic's ongoing merger discussions with Combustion. (JA 373-76)

On June 7, Kelly met with Muller, Ludwig and Caito at Basic's offices. (JA 107, 115-16) Kelly gave Muller the analyses of Basic prepared by Insley. (R. 137, Ex. 45; JA 107) Kelly then offered \$28 per share, payable in either cash or Combustion stock, for all of Basic's outstanding shares. (JA 332, 495) As stated in Muller's diary entry, "Office 9:00. Jim Kelly of CE offered \$28.00. . . ." (R. 137, Ex. 88, JA 495)

Muller responded to Kelly's \$28 offer by stating that the price of \$28 was "too low." (JA 332) Kelly then stated that Combustion would "give [Basic] Combustion's 'best' figure." (*Id.*) Because Muller had not yet received Kidder, Peabody's valuation of Basic, Muller asked Kelly to "hold off til we 'tell you' ", and he said that he would get back to Kelly the following week. (JA 248, 332, 382) Accordingly, Basic again contacted Kidder, Peabody and asked them to proceed with their analysis. (JA 249)

Following the June 7 meeting, Muller telephoned Rose. (JA 332) According to Rose's diary, on June 12, Rose spoke with Muller "re CE negotiation." (R. 137, Ex. 225) Muller informed Rose of the results of the meeting with Kelly, and arranged a meeting at Rose's office the following week. (JA 332)

On June 16, 1978, Muller, Ludwig, Caito and Rose met in Rose's office, and, at that meeting, they decided to ask Combustion to submit its "best offer." (JA 332) The decisions reached at the meeting were clearly summarized in Muller's notes:

"6-16-78

Cled [Cleveland], HCR's office. MJL AMC MM HCR

Discussed results of 'Kelly' meeting (6-7-78)—
Outlined plan

- a) Bring Kidder-Peabody in on an evaluation
- b) Have Steinhaus look at CE v/s Basic & USG [U.S. Gypsum] v/s Basic
- c) Ask CE for their 'best' offer, informally
- d) Up date Raid-defense Steinbrink

Kidder-Peabody" (JA 332)

Recognizing the materiality of Basic's negotiations with Combustion, Rose specifically advised Muller, Ludwig and Caito at the June 16 meeting that they should "stay out of the market." (JA 15-16)

Following the June 16 meeting, Caito was told to get financial information concerning Basic's and Combustion's refractories sales to Basic's outside counsel, Carl Steinhouse, to enable him to analyze the antitrust consequences of Combustion's acquisition of Basic. (JA 255-56) On June 20, Caito asked Steinhouse to investigate the antitrust consequences of the merger, as a result of which an antitrust study was done by Basic's counsel. (JA 174-76, 10-14)

On June 20, Muller called Kelly to ask for financial information about Combustion's sales, by industry segment, to assist Basic's lawyers in Basic's antitrust study. Kelly agreed to provide the information. Kelly told Muller that Combustion's lawyers had already made a "thorough study" of the possible antitrust consequences of the acquisition of

Basic. Muller and Kelly agreed that the lawyers should meet if Basic's lawyers saw any problems. (JA 333)

On June 20 and 23, Kelly gave Caito and Muller financial information concerning Combustion to assist Basic in preparing its antitrust analysis. (R. 137, Ex. 120; JA 333) On June 28, Muller and Caito met with Steinhouse to discuss the results of that study. Steinhouse's instructions were explicitly set forth in Muller's June 28 notes: "CS [Carl Steinhouse] says: go ahead." (JA 333)

On July 10, Muller met with Ludwig and Caito, and he then telephoned Kelly. In that conversation, Kelly and Muller agreed that Combustion would prepare an "informal offer" for Basic. (JA 333) As stated in Muller's notes:

"7-10-78 MSL-MM-AMC meet (Hermit C)
MM [Muller] returned Kelly's call:
Kelly will prepare an informal offer.
Advised against public
disclosure. MM informs K [Kelly]
that he'll ask Kidder-Peabody for appraisal."
(JA 333)

Kelly, apparently concerned that public disclosure would increase the price of Basic stock and the price Combustion would have to pay, urged Muller against public disclosure:

"Q. Mr. Kelly said to you that he didn't think it was advisable for you to make any kind of public disclosure of the fact that he was going to prepare an offer?

A. Correct." (JA 253)

On July 13, Kelly telephoned Muller and advised him that Combustion would meet with First Boston on July 14. Kelly asked Muller for Basic's latest confidential, non-public earnings projections for 1978. Muller gave Kelly a new estimate of "5,500,000 \$ plus." (JA 333, 253-55) Basic also provided Combustion with confidential, non-public

forecasts of its sales, earnings, costs, assets, and liabilities, broken down by each division of Basic's business, for each of the fiscal years ending 1978-1980. (R. 137, Ex. 32)

On July 11, Lambert Gross, Combustion's Financial Vice-President, telephoned First Boston's Perella to arrange a meeting with Santry, Kelly and representatives of First Boston the following week. (R. 137, Perella Ex. 6) At Combustion's request, First Boston prepared new analyses of various alternatives for the acquisition of Basic. (R. 137, Perella Exs. 6, 8, Ex. 27; JA 289-90) At the July 14 meeting, Kelly delivered a slide presentation to First Boston. (R. 137, Exs. 17, 210; JA 389) In that presentation, Kelly succinctly summarized Basic's "management goals":

"Basic Management Goals:

- (1) JOIN CE
- (2) GET FAIR PRICE
- (3) AVOID EXPOSURE
- (4) TAX FREE EXCHANGE" (R. 137, Ex. 17, p. 6; JA 389)

In his presentation, Kelly discussed alternatives for Combustion's acquisition of Basic at prices of about \$30 per Basic share, or some \$7 above the prevailing market price of Basic stock. (R. 137, Ex. 17, pp. 7-10; JA 389-91, 90-95)

Following the meeting with First Boston, Kelly and Santry called a special meeting of the Executive Committee of Combustion's Board to discuss the Basic acquisition. (JA 96-98; R. 137, Ex. 22) In preparation for that meeting, at Combustion's request, First Boston prepared analyses for the acquisition of Basic at prices of \$24-56 per share. (JA 384-86, 116-18)

On July 14, widespread rumors of ongoing merger discussions once again caused the price of Basic's stock to rise sharply. (JA 421-22, 453-54, 35-50; R. 137, Dolan Ex. 4)

Because of the highly unusual trading activity, the New York Stock Exchange issued a "Stock Watch Alert," and David Dolan, the Exchange's officer in charge of Basic stock, immediately telephoned Thomas, who had been designated as Basic's liason with the Exchange. (*Id.*) In the conversation, Dolan asked Thomas whether there were any "undisclosed merger or acquisition" plans, any developments relating to a possible tender offer, any "developments relating to prior announcements," or any other undisclosed corporate developments. In response, Thomas flatly denied that there were any corporate developments relating to any of the foregoing or any other matters. (*Id.*)

On July 18, Kelly and Muller had two telephone conversations. Muller told Kelly that the Exchange had made an inquiry to Basic concerning the unusual trading activity in Basic stock. (JA 271-72, 257-58, 334) At Kelly's request, Muller agreed to provide to Kelly additional non-public financial information concerning Basic's operations. (JA 334; R. 137, Exs. 42, 43, 216; JA 255-56, 258-60) As summarized in Muller's notes, Kelly "said that this would be a good time to 'test' Washington on account of the *Kaiser-Lavino* case." (JA 334)

On July 19, following another day of unusual trading activity in Basic stock, Kelly telephoned Muller again. (JA 388, 104-06) Because of Kelly's desire to allow the price of Basic stock "to fall back to more reasonable levels" (JA 338), and because of Muller's desire to get a valuation of Basic from Kidder, Peabody (JA 248-50), Kelly and Muller specifically agreed that Combustion and Basic should follow a "slow, deliberate approach" in proceeding with the merger. In his memorandum of the conversation to Santry, Kelly wrote:

"4) His [Muller's] antitrust lawyer is on vacation until August 3rd.

[Material redacted by Combustion's counsel]

What this means, is that we will not make any proposals to Basic until mid-August at the earliest. I believe such a program works in our favor in that it gives the stock a chance to fall back to more reasonable levels.

5) *Muller agrees that this slow, deliberate approach is the way to go.*" (JA 388) (emphasis added)

Just as significantly, Muller and Kelly agreed that Basic would continue to publicly deny the existence of any merger discussions, even though Muller and Kelly had just agreed to a "slow deliberate approach" in proceeding with the merger discussions. Thus, Kelly wrote:

"Muller's answer to any outside inquiry continues to be that Basic management knows nothing that could be causing the rise." (JA 388)

On July 21, Caito gave his outside counsel, Steinhouse, financial data for use in Steinhouse's antitrust analysis. (R. 137, Ex. 92) On July 21-22, Muller gave Kelly information concerning Basic's sales. (R. 137, Exs. 42, 43, 216) Kelly told Muller he wanted Combustion's lawyers and Basic's lawyers to make a joint antitrust analysis, and, following the July discussions, Combustion's and Basic's lawyers were in touch. (JA 118-22)

On July 27, the Executive Committee of Combustion's Board held a special meeting to discuss the Basic acquisition. Following a detailed presentation by Kelly, the Executive Committee authorized Combustion's management to "continue to proceed" with its negotiations and preparations to acquire Basic. (JA 394-95, 96-101)

Muller and Ludwig held meetings on August 11 and August 22 concerning Combustion. Ludwig's diary entry for August 22 further stated "MM (CAC) agenda CE 10.24" (JA 491), which entry Ludwig testified related to

the agenda for an upcoming meeting with Combustion. (JA 176-77)

Between September 9, 1978, and October 12, 1978, Muller was out of the country traveling through Europe on vacation. (JA 260-61) While Muller was gone, Kidder, Peabody continued its work on the valuation of Basic. (JA 261; R. 137, Parker Ex. 3) On August 28, Muller, Ludwig and Caito met to discuss "activities during absence of [Muller] and [Ludwig]," and on September 8, the day before Muller's departure for Europe, Muller, Ludwig and Caito met again to discuss the pending merger and acquisition discussions. (R. 137, Ex. H)

Only one week later, on September 11, Gross met with First Boston. (R. 137, SEC Ex. 3) On September 14, at Combustion's request, First Boston prepared a draft proposal letter for the acquisition of Basic by Combustion. (JA 401-02, 291-92) Using the name "Blank, Inc." to signify "Basic, Inc." and to preserve the confidentiality of the planned tender offer (R. 139, Perella Tr. 118-20), the draft proposal letter spelled out the terms of the proposed tender offer for Basic. (*Id.*) That same day, First Boston telecopied the proposal letter to Gross, and Gross delivered it to Kelly and Santry. (*Id.*; JA 401-02)

On September 25, Basic stock was again buffeted by widespread rumors of merger discussions. (R. 137, Dolan Exs. 5, 7; JA 422) Once again, the unusual trading activity in Basic stock triggered a "Stock Watch Alert" by the New York Stock Exchange. This time, Dolan, the Exchange official responsible for Basic stock, spoke to Ludwig. In response to Dolan's inquiries, Ludwig again flatly denied that there were any corporate developments relating to a possible merger or tender offer, or any other matters, and he said that he would therefore probably issue a "no corporate development" statement. (JA 51-60; R. 137, Dolan Exs. 5, 7; JA 422-23)

On September 25, 1978 Basic issued a statement to the press in which it represented:

"management is unaware of any present or pending corporate development that would result in the abnormally high trading activity and price fluctuation in company shares that have been experienced in the past few days." (JA 400-01)

The public statement was reported across the Dow Jones news service. (JA 402-03)

The September 25, 1978 public statement was not only issued for the specific purpose of dispelling the rumors of merger activity, but was issued by Basic in the very form prescribed by the New York Stock Exchange for situations in which, in fact, there are no ongoing merger discussions or other corporate developments. Thus, the New York Stock Exchange Listed Company Manual provided to the managements of all New York Stock Exchange listed companies, including Basic (R. 137, Ex. 66, Dolan Ex. 3; JA 524-60, 17-35, 302-04, 310-11), states:

"The market action of a corporation's securities should be closely watched at a time when consideration is being given to significant corporate matters. If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required. *If rumors are in fact false or inaccurate, they should be promptly denied or clarified. A statement to the effect that the company knows of no corporate developments to account for the unusual market activity can have a salutary effect. It is obvious that if such a public statement of this sort was contemplated, all levels of management should be checked prior to any public comment so as to avoid any embarrassment or potential criticism. If rumors are correct or there are developments, an immediate, candid statement to the public*

as to the state of negotiations or the state of development of corporate plans in the rumored area must be made directly and openly. Such statements are essential despite the business inconvenience which may be caused and even though the matter may not as yet have been presented to the company's Board of Directors for consideration." (R. 137, Ex. 66, p. 8; JA 535-36) (emphasis added).

On September 26, 1978, Ludwig spoke with Kelly. (R. 137, Ex. H) Ludwig and Kelly testified that they did not recall the purpose of the call or what was discussed, although they did recall discussing Basic's press release. (JA 123, 177-78)

On October 12, Muller returned from his trip. That same day, the FTC issued its ruling in the *Kaiser-Lavino* case holding that basic and non-basic refractories were separate "markets" for antitrust purposes. (R. 137, Ex. 201) Because of the *Kaiser-Lavino* decision, Kelly "was advised that this would be a good time . . . to get [the acquisition of Basic] done." (JA 122) Following Muller's return, Kelly and Muller arranged a meeting at Basic for November 27. (JA 334)

On November 6, 1978, and in order to dispel continuing rumors of merger activity, Basic issued a Nine Month Interim Report to Shareholders in which it again stated:

"With respect to the stock market activity in the Company shares, we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months." (JA 403) (emphasis added)

On November 21, one week prior to the November 27 meeting with Kelly, Muller telephoned Wilson in Florida for the purpose of again updating Wilson on the merger discussions with Combustion. In that conversation, Muller

and Wilson discussed Muller's expectation of an offer from Combustion in the \$45-50 range. (JA 407)

On November 27, Kelly met with Muller, Caito and Ludwig at Basic's offices. Kelly apologized to Muller and Ludwig for not having come back to them with his "best offer" earlier, and explained that the only reason had been the continuing high price of Basic's stock. Kelly suggested that Combustion acquire Basic for an all-cash price of \$35 per share. Muller, Ludwig and Caito told Kelly they thought that a higher price was more appropriate because of "the market history [of Basic stock] over the last six months" and the "earnings outlook of \$5 per share." (JA 408-09) As Kelly stated in his memo of the meeting:

"We left the meeting with an action program on their part which would be a review of whether cash or cash plus securities would be acceptable to them. . . ." (JA 408-09)

At Combustion's request, First Boston prepared analyses of various alternatives for acquiring Basic at prices ranging from \$30-\$50 per share. (R. 137, Exs. 28, 29, 30) On about December 11, Muller or Ludwig telephoned Kidder, Peabody and asked Siegel to come to Cleveland. (R. 147, pp. 121-23) Muller arranged for Kelly and Santry to meet with Basic's management on December 18 and 19, and Muller called a meeting of Basic's Directors to approve the transaction. On December 13, 14 and 15, meetings were held for most of the day in Basic's offices among the management of Basic and with Siegel. (Ex. H; JA 283) On December 14, the Executive Committee of Combustion's Board of Directors formally approved the acquisition of Basic at \$46 per share. (JA 411)

On Friday, December 15, 1978—only one business day before trading in Basic stock was halted on the New York Stock Exchange—Basic's stock soared once again, result-

ing in yet another stock watch inquiry. (R. 137, Dolan Exs. 9, 11) Once again, in response to the Exchange's inquiry, Thomas flatly denied to the Exchange that there were any corporate developments relating to a possible merger or tender offer. (JA 423, 62-5) On Monday, December 18, Basic asked the Exchange to suspend trading in its stock, and Basic issued a release in which it finally announced that it had been "approached" by an unidentified company for a merger. (JA 413)

On December 18, Kelly met with Muller, Ludwig and Caito. On December 19, Santry and Kelly met with Muller, Ludwig and Caito, and Muller accepted Combustion's offer of \$46 per share. (JA 335) Basic's Directors formally approved the \$46 per share price at a special meeting held that same day. (JA 414-16)⁹

⁹ During the very period when Basic was issuing its denials to the public and to the New York Stock Exchange, Muller was selectively advising Ted Mayer, an analyst with Legg Mason Wood Walker Incorporated, of merger approaches by various companies to Basic. Between January, 1978, and October or November, 1978, Mayer made more than 30 telephone calls to Muller. Although the approaches of other companies were clearly non-public information, Muller informed Mayer that Basic had been approached by companies interested in acquiring Basic on "at least half a dozen occasions" between his first conversation with Muller in or about January, 1978, and his last conversation with Muller in or about November, 1978. (JA 180-225; R. 143, Mayer SEC Tr. 150-80; R. 142, Mayer Tr. 82, 243-318; R. 137, Mayer Ex. 1)

Mayer's conduct leaves no doubt about the materiality of the information which he received from Muller and the materiality of the merger approaches to the "reasonable investor." Following his conversations with Muller about the merger approaches, Mayer broadcast the information which he had received from Muller "as soon as possible" to Legg Mason's other brokers by personal call, over the firm intercom, and at firm-wide sales meetings. (JA 220-25; R. 143, Mayer SEC Tr. 310-12, 204-08, 251; R. 142, Mayer Tr. 332-35; R. 137, Mayer Ex. 1; R. 137, Ex. J) As shown by a comparison of the records of telephone calls between Mayer and Muller (R. 137, Mayer Ex. 1) and the records of Legg Mason's trading in Basic stock (R. 137, Ex. J), Legg Mason's trading in Basic stock

(footnote continued on following page)

B. The District Court's Decisions

By Memoranda and Orders dated December 10, 1981, and February 17, 1982, the District Court granted respondents' motion for class certification on behalf of all persons who sold their Basic securities from October 21, 1977 (the date of Basic's first public statement) through December 15, 1978 (the last business day before Basic announced that it had been approached). (App. 113a-140a)

By Memorandum and Order dated August 3, 1984, the District Court granted petitioners' motion for summary judgment. (App. 21a-111a) Resolving conflicting views of the facts and the inferences to be drawn from the facts, the District Court held, as a matter of law, that a jury could not find Basic's ongoing merger discussions with Combustion to be material to the reasonable investor. (App. 103a) Based upon its conclusion that the Basic-Combustion merger discussions were not material, the District Court held that Basic's three denials were not false or misleading and that petitioners did not act with scienter. (App. 21a-111a)

C. The Sixth Circuit's Decision

By Decision dated March 27, 1986, the Court of Appeals reversed the District Court's grant of summary judgment and affirmed the grant of class certification. *Levinson v. Basic*, 786 F.2d 741 (6th Cir. 1986). The Sixth Circuit held that, while Basic was under no affirmative duty to disclose its merger discussions, once it chose to speak out, Basic was not free to issue false and misleading public statements:

(footnote continued from preceding page)

soared immediately following various of the conversations between Muller and Mayer. For example, immediately following Muller's telephone conversation with Mayer on July 10 or 12, 1978, Legg Mason's trading activity soared by more than 1,000% from an average of 600-800 shares per day to 8,300 shares on July 14, alone.

"If a corporation is not under a duty to disclose corporate information, but voluntarily chooses to make a statement and the statement is 'reasonably calculated to influence the investing public,' the corporation then has a duty to disclose sufficient information so that the statement made is not 'false or misleading or . . . so incomplete as to mislead.' *Texas Gulf Sulphur*, 401 F.2d at 862. See, e.g., *Etshokin v. Texasgulf, Inc.*, 612 F. Supp. 1220, 1227-29 (N.D. Ill. 1985); *Schlanger v. Four Phase Sys., Inc.*, 582 F. Supp. 128, 133-34 (S.D.N.Y. 1984). See also *In re Carnation Co.*, Sec. Exch. Act Rel. No. 22214 (July 8, 1985) [1984-85] Fed. Sec. L. Rep. (CCH) ¶ 83,801.

* * * As officers and spokespersons for a publicly traded company, the employees of Basic had a responsibility and duty to be truthful. The discretion they possessed was in speaking at all; once they spoke they could not be patently untruthful." *Id.* at 746-47.

Applying the test of materiality adopted in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), the Sixth Circuit found it "inconceivable" that a reasonable investor would not have considered Basic's merger discussions with Combustion to be important, and therefore material, to his or her investment decisions. *Id.* at 748. The Sixth Circuit wrote:

"The reasonable investor, having been informed that Basic knew of no corporate development that would result in the high trading activity, would, without doubt, have thought that disclosure of the fact that acquisition was being discussed 'significantly altered the "total mix" of information made available.'" *Id.*

The Sixth Circuit held that Basic's first public statement was "misleading, if not patently untrue," and that Basic's

latter two public statements were likewise "misleading, if not totally false." *Id.* at 747.

The Sixth Circuit also affirmed the District Court's grant of class certification. *Id.* at 749-51. In so ruling, the Sixth Circuit noted that the fraud on the market theory has consistently been applied to cases, such as this, in which investors have bought or sold shares on the impersonal market at prices directly affected by an issuer's public statements. *Id.* at 751.

Summary of Argument

1. As a general rule, a company is under no affirmative obligation to disclose its merger discussions. When, however, the company does speak out, it may not issue false or misleading statements. A statement violates Section 10(b) and Rule 10b-5 when it falsely represents facts or when, even if literally true, it "omit[s] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. . . ." See Rule 10b-5.

This Court held in *TSC Industries* that facts or events are material if there is "a substantial likelihood that a reasonable shareholder would consider [them] significant" to his or her investment decisions. 426 U.S. at 449. As the cases generally have held, and the markets have shown, there are few facts or developments deemed more significant to the reasonable investor, or to the price of a security on the exchange, than merger discussions. While a public company may generally be under no obligation to disclose its merger discussions, a company is not free to issue denials when merger discussions are, in fact, in progress. Here, Basic issued three denials for the very purpose of dispelling rumors of merger activity and in the very form prescribed by the New York Stock Exchange for situations in which, in fact, there are no merger discussions. Such public statements,

issued when a company is, in fact, engaged in merger discussions, are false and misleading and the omitted fact of such merger discussions is material to the "reasonable investor."

2. The Sixth Circuit correctly held—as has virtually every other court to consider the issue—that the fraud on the market doctrine should apply to create a "presumption of reliance" where an issuer disseminates false or misleading statements and investors buy or sell their securities on an exchange at prices directly affected by defendants' false or misleading statements.

The fraud on the market theory recognizes that when a company issues false or misleading public statements, those statements operate directly upon the marketplace to affect the prices at which investors buy or sell their securities. Likewise, investors have a right to rely upon the integrity of the marketplace and the assumption that the prices at which they buy or sell their securities are not affected by fraud or manipulation. Where investors buy or sell securities on an exchange, it is the reliance of the marketplace, and the impact of the issuer's statements upon the prices at which investors buy and sell, that establishes the causal link between the issuer's statements and the investor's injury. Investors who buy or sell securities on an exchange at prices which are artificially inflated or depressed by defendants' false or misleading statements should not be precluded from recovering the damages which they have suffered merely because they, themselves, did not read defendants' statements.

ARGUMENT

I. The Sixth Circuit Correctly Held That Summary Judgment Was Inappropriate in Determining Whether Basic's Public Statements Were Materially False or Misleading.

A. The Applicable Standards Under Section 10(b) and Rule 10b-5

Section 10(b) of the 1934 Act, and Rule 10b-5 thereunder, make it unlawful for an issuer to make public statements which are untrue or which, even if literally true, are misleading because of material omissions. Rule 10b-5 states in pertinent part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

* * *

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading

* * *

in connection with the purchase or sale of any security."

As a general matter, a public company is under no affirmative obligation to disclose its merger discussions. However, once the company does choose to speak out, Section 10(b) and Rule 10b-5 prohibit it from making false or misleading statements. As the Second Circuit held in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969),

"Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public . . . if such asser-

tions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes."

A public statement is false or misleading if it contains material misrepresentations or, in the words of Rule 10b-5, "omit[s] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. . . ." As this Court held in *TSC Industries*, 426 U.S. at 449,

"[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important. . . ."

Similarly, an omitted fact is material if there is

"a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*¹⁰

Because of the importance of the jury's assessment of what the "reasonable investor" would have considered to be significant, summary judgment is particularly inappropriate where the materiality of merger or takeover discussions is involved. See *SEC v. Shapiro*, 494 F.2d 1301, 1306 (2d Cir. 1974); *Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128, 134 (S.D.N.Y. 1984). Rather than "a specific rule as to when information respecting a merger becomes material," the courts have emphasized that materiality must be determined "on a case-to-case basis according

¹⁰ Although *TSC Industries* arose under Section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1981), and Rule 14a-9 thereunder, 17 C.F.R. § 240.14a (1986), subsequent decisions have applied its test of materiality to cases under Section 10(b) and Rule 10b-5. E.g., *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 466 n.4 (7th Cir.), cert. denied, 454 U.S. 835 (1981); *Goldberg v. Meridor*, 567 F.2d 209, 218 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978).

to the fact pattern of each specific transaction." *Shapiro*, 494 F.2d at 1306; *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 888 (2d Cir. 1972). Thus,

"[f]or the determination of whether information [concerning an unfolding merger transaction] is material or, alternatively stated, of whether such information would have affected the actions of a 'reasonable man' the jury is the appropriate body." *Radiation Dynamics*, 464 F.2d at 888.

As this Court wrote in *TSC Industries*,

"In considering whether summary judgment on the issue [of materiality] is appropriate, we must bear in mind that the underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. The determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact." 426 U.S. at 450.

In this case, Basic issued three public statements for the specific purpose of dispelling widespread rumors of merger discussions and affecting the price activity in Basic stock. In one instance, Basic flatly denied that there were any ongoing merger negotiations. In the other two instances, Basic issued public denials in the very form prescribed by the New York Stock Exchange for situations in which the rumors are false and there are, in fact, no merger discussions underway. See *supra* pp. 21-22. Basic issued those statements while Basic and Combustion were actively pursuing discussions for a merger.

As the Sixth Circuit held, the record is replete with evidence from which a jury could conclude that a reasonable investor would have deemed the ongoing discussions between Basic and Combustion to be material to his or

her investment decisions.¹¹ Indeed, the jury could conclude that the denials were issued by Basic with full knowledge that Combustion wanted to acquire Basic, that Basic wanted to merge with Combustion, that Basic was actively assisting Combustion in its preparations for a tender offer, and that the two companies were actively pursuing a merger.

B. Merger Discussions Are Material to the Reasonable Investor

As this Court held in *TSC Industries*, a fact or event is material if there is a "substantial likelihood that the reasonable shareholder would consider it important" to his or her investment decisions. In examining the materiality of facts or events, the trier of fact will ordinarily consider both "the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company[']s activity." *Texas Gulf Sulphur*, 401 F.2d at 849; see also *Shapiro*, 494 F.2d at 1305-06.

Applying the test adopted by this Court in *TSC Industries*, there can be little doubt that merger discussions are considered by the reasonable investor to be highly important to his or her investment decisions. (Brief for SEC at 9-11) Information about merger discussions generally has a significant impact upon the investment decisions of the reasonable investor and the price of a security on an exchange. (*Id.*) Indeed, there are few facts or developments likely

¹¹ On a motion for summary judgment, all facts and all reasonable inferences from the facts must be viewed in the light most favorable to the party opposing the motion. *Adickes v. S.H. Kress and Co.*, 398 U.S. 144, 157 (1970); see also *Matsushita Electric Industrial Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574 (1986). Summary judgment is improper unless the moving party can show as a matter of law that "there is no genuine issue as to any material fact. . . ." Fed. R. Civ. P. 56(c). The burden of establishing entitlement to summary judgment should be particularly high where, as here, the persons privy to discussions are the defendants and their own accounts of meetings and discussions will undoubtedly be biased.

to have as much of an impact as ongoing merger discussions. E.g., *Levinson*, 786 F.2d at 748; *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976) (Holding that even "embryonic" merger talks may be material to the reasonable investor); *Holmes v. Bateson*, 583 F.2d 542, 558 (1st Cir. 1978) (Finding it "inconceivable" that a reasonable investor would not consider preliminary merger discussions to be significant to his or her investment decisions); *Flamm v. Eberstadt*, 814 F.2d 1169, 1174 (7th Cir. 1987).¹²

Moreover, a merger is such a significant event that the existence of merger discussions becomes material at a far earlier stage than would developments relating to lesser transactions. As Judge Friendly emphasized in *Geon Industries*, 531 F.2d at 47-48:

"[*SEC v. Texas Gulf Sulphur*] makes clear that not only the probability of an event but also the magnitude of its potential impact on a company's fortunes are relevant to the determination of materiality of inside information, 401 F.2d at 849.

* * *

As we said in *SEC v. Shapiro*, 494 F.2d 1301, 1306 (2d Cir. 1974) . . . the application of this test implies that there is "[no] specific rule as to when information

¹² Recent developments in the area of insider trading reaffirm the materiality of preliminary merger discussions. The willingness of professionals to invest large sums on the basis of their privileged access to information about preliminary merger discussions, and the huge profits which they have been able to reap by trading upon such information, indicate the importance which investors attach to such information. (Brief for SEC at 10-13) As one commentator has written:

"As market activity based on acquisition rumors in case after case has shown, preliminary merger or takeover discussions are significant to investors in the target's securities and no amount of well-intentioned judicial rationalization in the search for bright-line rules can make that simple fact of materiality disappear." Olson, *Revealing Merger Talks: When, How Are Critical*, LEGAL TIMES, Oct. 14, 1985, at 22.

respecting a merger becomes material,¹³ but rather indicates that each case must be approached on its own facts. Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high.”

Where developments within a corporation have significantly increased the likelihood of a merger, or where developments may otherwise affect the value of a holder's investment, those developments are material. Although a public company is under no affirmative obligation to disclose its merger discussions and is free to remain silent or to issue a “no comment” statement, a public company is not free under Section 10(b) and Rule 10b-5 to issue false or misleading statements designed to dispel rumors of merger activity when, in fact, merger discussions are underway.

With the single exception of the Third Circuit's decision in *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985), the courts and the SEC have held that public denials of the sort issued by Basic are false or misleading if issued while a company is in fact involved in discussions for its merger or acquisition.¹³

¹³ In *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982), *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983), and *Flamm*, all of which are relied upon by petitioners (Brief for Petitioners), and in *Jordan v. Duff and Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), cited by the SEC (Brief for SEC at 14), defendants had been silent on the subject of their merger discussions. The issue in those cases was whether defendants were under an affirmative duty to disclose their merger discussions, not whether defendants were free to issue false or misleading denials while engaged in merger discussions. None of these cases suggest that issuers are free to issue denials when, in fact, merger discussions are underway. See *infra* pp. 40-42.

E.g., *Levinson*, 786 F.2d 741; *Schlanger*, 582 F. Supp. 128 (“No corporate developments” statements are false or misleading where preliminary merger discussions are in fact underway); *In re Carnation Co.*, Exchange Act Release No. 22214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (SEC July 8, 1985) (same); see also *Rowe v. Maremont Corp.*, 650 F. Supp. 1091, 1107 (N.D. Ill. 1986) (Following Sixth Circuit's decision in *Levinson*); *Etshokin v. Texasgulf, Inc.*, 612 F. Supp. 1212, 1217 (N.D. Ill. 1984).

In *Schlanger*, for example, defendants had issued a public statement in response to similar rumors of merger activity and inquiries about trading activity by representatives of the New York Stock Exchange. In the public statement, defendants represented that the company was “not aware of any corporate developments which would affect the market of its stock,” even though the defendants were in fact engaged in merger discussions with another company. 582 F. Supp. at 129. The defendants argued that they were under no affirmative duty to disclose the merger discussions, and that the merger discussions were not “material” because no formal offer had yet been made. In rejecting those arguments, the court held:

“This Court agrees that summary judgment cannot be granted in defendants' favor with respect to the issues of duty and materiality, and that contested issues of fact are present in this case. While the federal securities laws do not impose a general duty upon an issuer to disclose material facts or new developments when it is not trading in its own securities, it does have a duty to make certain that any statement it does issue is truthful and complete, and does not materially misrepresent the facts existing at the time of the announcement. *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860-62 (2d Cir. 1968) (*en banc*),

cert. denied, 394 U.S. 976, 89 S. Ct. 1454, 22 L. Ed. 2d 756 (1969); see also *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 853 (2d Cir. 1981). In this case, defendants *did* make an announcement, intended to be relied on by purchasers and sellers, and therefore had a duty to make a statement which was both truthful insofar as it went, and not misleading in light of the facts known at that time." *Id.* at 133 (emphasis added).

The Court further held that

"defendants, once having chosen to make a statement of fact, had a duty to disclose all material facts 'necessary in order to make the statement made, in light of the circumstances under which it was made, not misleading.'" *Id.* at 134 (quoting Rule 10b-5).

Similarly, in *In re Carnation Co.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 at 87,595, the SEC held that the issuance of a "no corporate developments" statement while merger discussions are underway is both false and misleading:

"Whenever an issuer makes a public statement or responds to an inquiry from a stock exchange official concerning rumors, unusual market activity, possible corporate developments or any other matter, the statement must be materially accurate and complete. If the issuer is aware of nonpublic information concerning acquisition discussions that are occurring at the time the statement is made, the issuer has an obligation to disclose sufficient information concerning the discussions to prevent the statements made from being materially misleading. [Citing *Schlanger v. Four-Phase Systems, Inc.*]"

Section 10(b) and Rule 10b-5 make it unlawful for a public company or its officers to issue false or misleading denials of such merger activity, to trade while in possession

of knowledge of such activity, or to tip third parties that such discussions are underway.¹⁴

C. Petitioners' Contention That Merger Discussions Are Not Material Until an Agreement in Principle Has Been Reached Should Be Rejected

Petitioners argue that merger discussions should not be deemed material in the absence of an agreement in principle to merge, even when a public company issues a series of public statements for the very purpose of dispelling rumors of merger activity. (Brief for Petitioners at 20-26)

Petitioners do not appear to suggest that the "reasonable investor" would not have considered Basic's ongoing merger discussions with Combustion to be significant to his or her investment decisions—the standard of materiality adopted by this Court in *TSC Industries*. Instead, petitioners urge the adoption of a *per se* rule that merger discussions should not be material in the absence of an agreement in principle to merge for three reasons: (a) because disclosure of preliminary negotiations may be misleading to shareholders; (b) because premature disclosure may affect the success of merger discussions; and (c) because an agreement in principle test provides a "bright line" measure of materiality.

As stated in the SEC's brief, the first rationale assumes that corporations are incapable of communicating effectively and truthfully and that shareholders cannot understand the risk that preliminary merger discussions may

¹⁴ See, e.g., *Holmes*, 583 F.2d at 558; *Shapiro*, 494 F.2d at 1306-07 (Rejecting a defendant's claim that preliminary discussions were not material because the "possibility of a merger was always remote"); *Rogen v. Ilikon Corp.*, 361 F.2d 260, 266 (1st Cir. 1966); *Dungan v. Colt Industries, Inc.*, 532 F. Supp. 832, 837 (N.D. Ill. 1982) (Fact that defendants were exploring the sale of their company was material); *American General Insurance Co. v. Equitable General Corp.*, 493 F. Supp. 721, 744-45 (E.D. Va. 1980) (Merger discussions were material months before agreement in principle was reached); *Levin v. Marder*, 343 F. Supp. 1050, 1058 (W.D. Pa. 1972) (Preliminary merger discussions "may well be material").

or may not lead to a transaction. (Brief for SEC at 15) Public companies can, and they generally do, act in a truthful and forthright manner without issuing false or misleading statements. Faced with similar rumors of merger activity, other public companies have chosen from a variety of options—either to remain silent, to issue a “no comment” statement, to issue truthful public statements that the company has been approached or is in “preliminary discussions,” or to issue other forms of statements along the lines suggested by the New York Stock Exchange.¹⁵ More significantly, an issuer is under no affirmative duty to speak out at all; it is free to remain silent. Once the issuer does choose to speak, Section 10(b) and Rule 10b-5 do not permit the issuer to disseminate false or misleading denials.

The second rationale suggested by petitioners is that premature disclosure may affect merger negotiations. Since public companies are under no affirmative duty to disclose their merger negotiations, and are free to remain silent, the holding of the Sixth Circuit in no way requires pre-

¹⁵ Copies of sample statements made by other public companies during the years 1981-83 are included as R. 137, Ex. G. See, e.g., *Wall Street Journal* (“WSJ”), Vol. CXC VII, No. 17, p. 26 (Jan. 26, 1981) (Announcing that the company was in “preliminary discussions”); *WSJ*, Vol. CXC VII, No. 17, p. 37 (Jan. 26, 1981) (same); *WSJ*, Vol. CXC VII, No. 68, p. 10 (April 8, 1981) (Announcing that the company was “discussing a possible merger”); *WSJ*, Vol. CXC VII, No. 94, p. 8 (May 14, 1981) (Company in “discussions” about possible merger); *WSJ*, Vol. CXC VII, No. 118, p. 8 (June 18, 1981) (Joint release announcing that companies are engaged in preliminary merger discussions); *WSJ*, Vol. CXC VIII, No. 50, p. 37 (Sept. 10, 1981) (Companies holding merger discussions); *WSJ*, Vol. CXC VIII, No. 54, p. 42 (Sept. 16, 1981) (Announcing preliminary discussions); *WSJ*, Vol. CXC VIII, No. 59, p. 7 (Sept. 23, 1981) (same); *WSJ*, Vol. CXC IX, No. 4, p. 32 (Jan. 7, 1982) (same); *WSJ*, Vol. CXC IX, No. 13, p. 28 (Jan. 20, 1982) (same); *WSJ*, Vol. CXC IX, No. 26, p. 8 (Feb. 8, 1982) (same); *WSJ*, Vol. CXC IX, No. 65, p. 8 (April 5, 1982) (same); *WSJ*, Vol. CXC IX, No. 100, p. 29 (May 24, 1982) (same); *WSJ*, Vol. CXC IX, No. 118, p. 37 (June 18, 1982) (same). See also New York Stock Exchange, *NYSE Listed Company Manual* § A2(II) (1977) (JA 433-35, 534-36).

mature disclosure—or any disclosure for that matter—of merger discussions. The Sixth Circuit’s decision, and Section 10(b) and Rule 10b-5, simply prohibit a public company from issuing false or misleading denials.

The final justification suggested by petitioners—the need for a “bright line” test—is also misplaced because the importance of merger discussions to the reasonable investor, and hence their materiality, will depend upon the facts and circumstances of each case. *Radiation Dynamics*, 464 F.2d at 888 (Materiality of merger discussions should be determined on a case-by-case basis); *Shapiro*, 494 F.2d at 1306 (Declining to adopt a fixed rule as to when information about merger discussions becomes material). Only recently, the House Committee on Interstate Commerce urged the SEC against any effort to adopt a “bright line” definition of materiality. See Staff of House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Sess., *Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission* 327 (Comm. Print 1977).¹⁶ A fixed, “bright line” test of materiality would be over-inclusive in some cases and under-inclusive in others.

Moreover, the agreement in principle test proposed by petitioners would freely permit public companies to issue false, misleading, and manipulative denials up until the time when an agreement in principle has been reached. Merger discussions generally become material to the reasonable

¹⁶ As stated in the Committee Report:

“Although the Committee believes that ideally it would be desirable to have absolute certainty in the application of the materiality concept, it is its view that such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula. The Committee’s advice to the Commission is to avoid this quest for certainty and to continue consideration of materiality on a case-by-case basis as problems are identified.”

investor well before the parties reach an agreement in principle to merge. Corporations should not be free to issue false or misleading denials simply because an agreement in principle has not been reached.

In support of their proposed rule that denials should not be deemed false or misleading in the absence of an agreement in principle to merge, petitioners rely upon a series of cases commencing with *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982) and *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983), and including *Greenfield*, 742 F.2d 751, and *Flamm*, 814 F.2d 1169. With the exception of *Greenfield*, which other courts have generally declined to follow, petitioners' cases are inapposite.

Staffin and *Reiss* both involved alleged failures to disclose merger discussions, not the issuance of false or misleading denials. Indeed, in *Staffin*, the defendants had actually issued a statement that they were involved in "exploratory talks." 672 F.2d at 1201. In *Staffin* and *Reiss*, the issue was whether defendants were under an affirmative duty to disclose merger discussions, not whether defendants were free to deny rumors of merger activity while they were in fact engaged in merger discussions.

Likewise, *Flamm* was not a case involving the denial of merger discussions, but was, as the Seventh Circuit itself emphasized, "a case of silence on the subject of the omitted information." 814 F.2d at 1179. Not only did the Seventh Circuit expressly decline to decide whether it would apply the Sixth Circuit's decision in *Levinson* or the Third Circuit's decision in *Greenfield* to the issuance of public denials, but the Court specifically distinguished this case:

"None of the statements [in *Flamm*] denied that the firm was searching for higher bids; the implication of the statement [issued in *Flamm*] that General

Cable's bid is 'inadequate' is the contrary. *Levinson*, in contrast, dealt with five bald denials that the firm was attempting to arrange a merger." *Id.*

The single decision cited by petitioners involving the obligations of a company when it chooses to issue denials of merger activity is *Greenfield*. In *Greenfield*, a panel of the Third Circuit—over the dissent of one of the three judges on the panel—held on somewhat different facts that preliminary merger discussions are immaterial as a matter of law in the absence of an agreement in principle to merge.¹⁷ As the Sixth Circuit, other courts, and the SEC have held in cases involving denials of merger activity, the rule adopted in the *Greenfield* decision is inconsistent with the language and policies of Section 10(b) and Rule 10b-5 and the standard of materiality adopted by this Court in *TSC Industries*. See, e.g., *Levinson*, 786 F.2d at 748-49; *Schlanger*, 582 F. Supp. at 132-34; *In re Carnation*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 at 87,596 n.8; see also *Rowe*, 650 F. Supp. at 1106-07.

D. Basic's Public Statements Were False or Misleading

Finally, petitioners argue that Basic's first public statement—stating that "no negotiations were underway with any company for a merger"—was not literally false because Basic's discussions with Combustion should not be characterized as "negotiations," and that Basic's last two state-

¹⁷ In *Greenfield*, at the time of the public statement at issue, Heublein, the issuer, had been trying to avoid the possibility of a hostile tender offer by General Cinema, whose purchases of Heublein stock were a matter of public record. As a defensive maneuver, Heublein had discussed the possibility of merger with R.J. Reynolds if, and only if, Heublein could not deter General Cinema from making a hostile tender offer. Here, by contrast, Basic was involved in active merger discussions with Combustion and was actively assisting Combustion's merger preparations for more than a year. In his dissent in *Greenfield*, Judge Higginbotham would have found Heublein's public statement to be false or misleading for the reasons adopted by the Sixth Circuit in this case. 742 F.2d at 760-61.

ments—which denied “any present or pending developments” which would account for the activity in Basic stock—were not literally false because Basic did not know the reasons for the trading activity.

Section 10(b) and Rule 10b-5 make it unlawful for a public company to issue a public statement which is false or which, even if literally true, is misleading because of material omissions. See Rule 10b-5; *Texas Gulf Sulphur*, 401 F.2d at 862. Public statements are actionable if they misrepresent the facts or, if, even though literally true, they create a misleading impression in the minds of the reasonable investor. *Id.*; *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1313 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978); *Rowe*, 650 F. Supp. at 1105.

In this case, Basic issued one statement that “no negotiations were underway with any company for a merger” and two statements that there were “no significant corporate developments” which would account for the activity in the stock. Each of the statements was issued for the conceded purpose of dispelling widespread rumors of merger discussions. The latter two statements were issued in the very form prescribed by the New York Stock Exchange for situations in which there are, in fact, no merger discussions underway.

As the Sixth Circuit held, the first statement was “misleading, if not patently untrue” because it could, and in all likelihood would, signify in the mind of the reasonable investor that the type of discussions which were in fact going on were not occurring. At the very least, the first statement is the type of misleading statement—failing to disclose those additional facts needed to make the statement not misleading—which Section 10(b) and Rule 10b-5 were intended to prevent.

Likewise, the latter two statements were found by the Sixth Circuit to be “misleading, if not totally false.” Those

statements could, and in all likelihood would, be read by the reasonable investor as representing that there were no significant corporate developments which, if disclosed, would affect or account for the activity in the stock. Those statements were issued in the very form intended by the New York Stock Exchange to suggest that no merger discussions were underway, and they were likewise intended by Basic for the specific purpose of dispelling rumors of merger activity when, in fact, merger discussions were being actively pursued by both Basic and Combustion. The statements were false, or at the very least misleading, because they failed to disclose sufficient facts needed to render them not misleading in the mind of the reasonable investor. *E.g.*, *Schlanger*, 582 F. Supp. 128 (Finding nearly identical statements to be false and misleading); *In re Carnation*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 at 87,593 (same).

II. The District Court and Sixth Circuit Properly Applied the Fraud on the Market Doctrine in Granting and Affirming Class Certification.

A. The District Court and Sixth Circuit Correctly Followed the Fraud on the Market Doctrine

In challenging the propriety of class certification, petitioners contend that both the Sixth Circuit and the District Court erred in following the fraud on the market doctrine.

The Sixth Circuit correctly held—as has virtually every other court to consider the issue over the past 12 years¹⁸—

¹⁸ *Flamm*, 814 F.2d at 1179-80; *Peil v. Speiser*, 806 F.2d 1154, 1160-63 (3d Cir. 1986); *Lipton v. Documentation, Inc.*, 734 F.2d 740, 745-48 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot after cert. granted*, 459 U.S. 1027 (1982); *Wachovia*

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that the fraud on the market doctrine should be applied to create a rebuttable presumption of reliance where false or misleading public statements have been disseminated by an issuer into an impersonal market and investors have bought or sold their securities on an exchange at prices artificially inflated or deflated by the issuer's public statements.

Neither Section 10(b) nor Rule 10b-5 contains any express reference to reliance or to a reliance requirement.¹⁹ The fraud on the market doctrine—which represents a refinement of the judicially created reliance requirement in the context of open market purchases and sales of securities—rests upon several sound and accepted bases.

First, when defendants issue false or misleading public statements into a developed and impersonal market, those

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Bank & Trust Co., N.A. v. National Student Marketing Corp., 650 F.2d 342, 358 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981); *Ross v. A.H. Robins Co., Inc.*, 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Arthur Young & Co. v. United States District Court*, 549 F.2d 686, 694-95 (9th Cir.), *cert. denied*, 434 U.S. 829 (1977); *Blackie v. Barrack*, 524 F.2d 891, 905-08 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982); *In re LTV Securities Litigation*, 88 F.R.D. 134, 142 (N.D. Tex. 1980).

Likewise, the fraud on the market theory has been endorsed by commentators in cases involving well developed markets. Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 GEO. WASH. L. REV. 627 (1982).

¹⁹ Although Section 10(b) and Rule 10b-5 contain no express reference to reliance or to a reliance requirement, a requirement of reliance has been judicially implied in the absence of a fraud on the market to establish the causal relationship between an issuer's fraud and an investor's injury. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). Where, however, an issuer disseminates false or misleading public statements into an impersonal marketplace directly impacting the prices at which investors buy or sell their securities, causality is clearly established, as is the reliance of the marketplace generally upon the issuer's false and misleading statements.

statements directly affect the prices at which investors buy or sell their securities on an exchange. *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986); *Lipton v. Documentation, Inc.*, 734 F.2d 740, 745 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *Blackie v. Barrack*, 524 F.2d 891, 906-08 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). Investors who bought or sold their securities on the open market at prices artificially inflated or deflated by defendants' public statements should not be precluded from recovering the losses directly resulting from defendants' public statements merely because they, themselves, did not read defendants' false or misleading statements. *Id.*

Second, when investors buy or sell securities on the open market, they rely generally upon the integrity of the market and the belief that the prices set by the marketplace are not the result of false and misleading statements or market manipulation. *Peil*, 806 F.2d at 1160-61; *Blackie*, 524 F.2d at 907-08. Indeed, it is difficult to imagine that investors would be in the market if they believed that prices were being manipulated by false or misleading statements. *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982).

Third, while actual reliance is generally needed to establish a causal link between a defendant's fraud and a plaintiff's injury in other contexts, that causal relationship is fully established in the context of open market purchases and sales where an issuer has disseminated into the marketplace false or misleading public statements which artificially inflate or deflate the prices at which investors buy or sell their securities on an exchange. In open market transactions on an exchange, it is the reliance of the marketplace upon an issuer's public statements, and the impact of those statements upon the prices at which an investor buys or sells his or her securities, which establish the causal link between the false or misleading statements and the losses

which investors have suffered. *Peil*, 806 F.2d at 1160-61; *Blackie*, 524 F.2d at 907.²⁰

In enacting the 1934 Act, Congress emphasized its intent to insure the "maintenance of fair and honest" markets and to proscribe the dissemination of false or misleading statements which would injure investors through their fraudulent impact upon the market. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 10 (1934). As stated in the House Report:

"The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy." *Id.* at 11.

The fraud on the market doctrine clearly furthers the purposes of the 1934 Act. Where an issuer has disseminated public statements calculated to affect the marketplace and the prices at which investors buy or sell their securities on an exchange, persons who buy or sell their securities at prices directly affected by false or misleading statements

²⁰ As the Third Circuit stated in *Peil*, 806 F.2d at 1160-61:

"The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. See Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143, 1154-56 (1982). Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations."

are the very persons whom Section 10(b) and Rule 10b-5 were intended to protect, and they should not be precluded from recovering the losses which they have suffered simply because they, themselves, did not read the issuer's statements.

In *Blackie*, 524 F.2d at 907 (affirming a class certification), the Ninth Circuit set forth the principal policies underlying the fraud on the market doctrine:

"A purchaser on the stock exchanges may be either unaware of a specific false representation, or may not directly rely on it; he may purchase because of a favorable price trend, price earnings ratio, or some other factor. Nevertheless, he relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price—whether he is aware of it or not, the price he pays reflects material misrepresentations. Requiring direct proof from each purchaser that he relied on a particular representation when purchasing would defeat recovery by those whose reliance was indirect, despite the fact that the causal chain is broken only if the purchaser would have purchased the stock even had he known of the misrepresentation."²¹

²¹ As this Court has held, "[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388 (1983) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744-45 (1975)). Thus,

"[T]he antifraud provisions of the securities laws are not co-extensive with common-law doctrines of fraud. [citation omitted] Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of

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The fraud on the market doctrine does not relieve the plaintiffs of their burden of establishing the damages which were suffered and the amounts, if any, by which the prices of securities traded over the exchange were artificially inflated or deflated by defendants' conduct. Nor does the doctrine preclude defendants from establishing that the fraud on the market doctrine should not apply because the false or misleading public statements did not artificially inflate or deflate the prices at which securities were bought or sold. Those are issues for the trier of fact.

Likewise, the fraud on the market doctrine does not eliminate the role of causality or reliance. Rather, the doctrine recognizes that it is the reliance of the marketplace, generally, and the reliance of the investor upon the integrity of the market, that connect a false and misleading statement with the losses which investors suffer.²³

B. The Other Provisions of the 1933 and 1934 Acts Do Not Contradict the Fraud on the Market Doctrine Under Section 10(b)

Several of the *amici curiae* argue that, because Section 18 of the 1934 Act, 15 U.S.C. § 78r (1981), contains an explicit requirement that a plaintiff have read and relied upon a document filed with the SEC, and because Section 11 of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77k (1981), contains a requirement that a plaintiff have read and relied upon an initial registration statement, a

(footnote continued from preceding page)

conduct in the securities industry." *Herman & MacLean*, 459 U.S. at 388-89.

See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1983).

²³ Petitioners contend that the fraud on the market theory should not apply to a class of persons who sell their securities at artificially depressed prices. That position ignores the bases of the doctrine and is likewise contrary to the relevant decisions.

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similar requirement should be implied into Section 10(b) so as to preclude the fraud on the market doctrine.²³

Section 18, Section 11, and Section 10(b) are distinct statutory provisions which are directed at different problems and have very different requirements of proof. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983); *Wachovia Bank & Trust Co., N.A. v. National Student Marketing Corp.*, 650 F.2d 342, 354-57 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981); *Ross v. A.H. Robins Co., Inc.*, 607 F.2d 545, 551-56 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980). Section 18 creates a remedy for damages resulting from filings with the SEC; it requires no showing of scienter; it contains a one-year statute of limitations and a provision that plaintiffs may be required to post security for costs; and it contains an explicit requirement of actual reliance. 15 U.S.C. § 78r; *Wachovia*, 650 F.2d at 357; *Ross*, 607 F.2d at 552-53. Likewise, Section 11 allows purchasers of securities in an initial public offering to sue certain enumerated persons for false or misleading information included in a registration statement; it, too, contains

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Just as purchasers are directly injured by false and misleading statements which inflate the price of an issuer's securities, sellers are directly injured when a corporation issues false or misleading public statements depressing the prices at which investors sell. In each case, an issuer's statements act as a fraud on the marketplace causing the buyers, or sellers, their losses. As the courts have uniformly held, buyers affected by an artificially inflated market and sellers affected by an artificially depressed market are each entitled to rely upon the fraud on the market doctrine. See, e.g., *Schlanger*, 555 F. Supp. at 538-39 (class of sellers in case involving similar facts); *Friedlander v. Barnes*, 104 F.R.D. 417 (S.D.N.Y. 1984) (same); *Greenfield v. Flying Diamond Oil Corporation*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,942 at 90,809 (S.D.N.Y. 1981) (class of sellers); *Staffin v. Greenberg*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,385 at 97,534 (E.D. Pa. 1980) (same).

²³ See Brief for American Corporate Counsel Association at 12; Brief for Arthur Andersen & Co., *et al.*, at 7-12; Brief for American Institute of Certified Public Accountants at 6-12.

no scienter requirement; and it contains a one-year statute of limitations and a security for costs provision. 15 U.S.C. § 77k (1981); *Herman & MacLean*, 459 U.S. at 383.

By contrast, Section 10(b) was intended as a broader, "catch-all" provision which covers a variety of fraudulent practices, including manipulation of the securities markets and issuance of false or misleading public statements. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-04 (1976). Unlike a plaintiff under Sections 11 and 18, a plaintiff under Section 10(b) must establish that defendants acted with scienter. *Id.* Section 10(b) contains no reference to any requirement of reliance, and the applicable limitations period is determined under state law. *Id.* at 210 n.29.

Because Section 10(b) contains a far higher standard of culpability—requiring a showing of scienter—Section 10(b) does not eclipse the other two sections and is in no way inconsistent with them. Likewise, there is no inconsistency in the fact that various limitations upon claims under Sections 11 and 18 do not appear in Section 10(b) and have not been implied in it.

The arguments advanced by *amici curiae* are similar to the arguments which have been made, and rejected, in other cases. In *Herman & MacLean*, for example, defendants argued that purchasers of securities in a registered offering should be required to sue under Section 11 of the 1933 Act, rather than Section 10(b), because allowing suits under Section 10(b) in cases arguably covered by Section 11 would effectively nullify the limitations included in Section 11. This Court held that Section 11 did not limit the assertion of claims under Section 10(b). As this Court stated, a claimant under Section 10(b) carries a far heavier burden of proof than a Section 11 plaintiff. 459 U.S. at 382. Moreover, as the Court noted, the securities laws were intended to contain overlapping and, in many instances, "cumulative" remedial provisions with varying

requirements and differing limitations. *Id.* at 383.²⁴ In *Wachovia* and *Ross*, similar claims were rejected that the limitations of Section 18 would somehow be frustrated by allowing plaintiffs to pursue their claims under Section 10(b), rather than under Section 18.

The fact that Section 18 of the 1934 Act and Section 11 of the 1933 Act include statutory requirements of actual or subjective reliance—as well as other requirements which are not contained in Section 10(b)—does not mean that those requirements should be implied into Section 10(b), any more than it means that a claimant must assert his claims under Section 11 or Section 18, rather than Section 10(b), because he or she is arguably within the scope of those other provisions. If express limitations in other provisions were to be implied into Section 10(b), then it could be argued that limitations under any of the other sections of the federal securities laws would be implied into Section 10(b) if those other provisions, with their limitations, could have been applied to a given set of facts.²⁵

Far from supporting the claims of *amici curiae*, the history of the 1934 Act reinforces the fraud on the market theory. Denial of the fraud on the market theory in Section 10(b) cases would prevent a large proportion of those investors who bought or sold securities on an exchange

²⁴ In addition, Congress enacted savings provisions in both the 1933 and 1934 Acts to assure that the rights and remedies in one statutory provision would not be construed to limit rights and remedies in others. *Id.* at 381-82; see also Section 16 of the 1933 Act, 15 U.S.C. § 77p (1981), and Section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a) (1981).

²⁵ Section 10(b) and Rule 10b-5 proscribe a broad range of fraudulent conduct for which the requirement of reliance is inapposite, including illegal trading on inside information, unlawful tipping, and market manipulation. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977). Likewise, this Court has held that where omissions are involved, the concept of reliance is inapplicable and reliance is to be presumed from the materiality of the omission. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972).

at prices directly inflated or depressed by false or misleading statements from recovering their losses simply because they, themselves, did not read the statements. As this Court recently emphasized in *Herman & MacLean*,

"[W]e have repeatedly recognized that securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.'" 459 U.S. at 386-87 (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

C. Petitioners' Remaining Arguments Should Be Rejected

Petitioners and several of the *amici curiae* also argue (a) that the fraud on the market doctrine is inconsistent with this Court's decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), and that the doctrine will expand the category of claimants to unjustified and unwarranted proportions; (b) that the doctrine violates the Rules Enabling Act, 28 U.S.C. § 2072 (1981); and (c) that the fraud on the market theory should be found inapplicable to this case because of the length of the class period.²⁶

In *Blue Chip*, this Court held that persons who neither bought nor sold securities could not meet the requirement of Section 10(b) and Rule 10b-5 of a fraud suffered by them "in connection with the purchase or sale" of securities. The Court rejected claims of persons who were neither purchasers nor sellers in view of the explicit requirement of a "purchase or sale" in the statute. 421 U.S. at 733-34. The Court was also concerned that a potentially limitless group of persons, who had neither bought nor sold securities, and who may not have suffered any injury, could

²⁶ Brief for Petitioners at 38-43; Brief for Arthur Andersen & Co., *et al.* at 3-5; Brief for American Corporate Counsel Association, *et al.* at 11-16; Brief for American Institute of Certified Public Accountants at 25-29.

assert claims based upon unilateral assertions that they would have bought or sold a security had they known the true facts.

Far from expanding the scope of recovery to persons who have suffered no injury, the fraud on the market theory allows those who *have* made purchases or sales of securities at prices affected by false or misleading statements to recover their damages. Proof of a fraud on the market and the impact upon the price at which investors bought or sold may be established through objective facts and proof. Twelve years of application of the fraud on the market theory, and the endorsement of the doctrine by virtually every court to consider the issue, have shown that the theory has not resulted in "limitless" class actions by undeserving class members, but rather has served to ensure that injured persons may invoke those rights which Section 10(b) and Rule 10b-5 were intended to protect.²⁷

Petitioners' next argument—that the fraud on the market doctrine violates the Rules Enabling Act—is misplaced because the fraud on the market doctrine is not limited to class actions, but, rather, is applicable to any action in which the plaintiff may establish that he bought or sold

²⁷ One *amicus curiae* contends that a corporation which makes false or misleading representations cannot be held to have made those "in connection with the purchase of any security," as required by Section 10(b), unless the issuer actually engaged in the securities transaction. Brief for American Corporate Counsel Association, *et al.*, at 11-13. That argument has been uniformly rejected since *Texas Gulf Sulphur*, 401 F.2d at 860. Where false or misleading public statements are issued for the very purpose of affecting the prices at which investors buy or sell their securities, those statements are made "in connection with" the investors' purchases and sales. See, e.g., *Brown v. Ivie*, 661 F.2d 62, 65 (11th Cir. 1981), *cert. denied*, 455 U.S. 990 (1982); *In re Warner Communications Securities Litigation*, 618 F. Supp. 735, 752 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986) (and cases cited therein). Cf. *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6 (1971) (Deceptive practices need only touch on the sale of purchase of securities).

securities in an open market at prices artificially inflated or depressed by defendants' false or misleading statements. *Blackie*, 524 F.2d at 908; see also *Tucker v. Arthur Andersen & Co.*, 67 F.R.D. 468, 480 (S.D.N.Y. 1975).

Petitioners' final argument—that respondents will be unable to establish that Basic's repeated false and misleading statements impacted the price of Basic stock over a fourteen month period—represents an effort to litigate the merits of this case on the motion for class certification which was properly rejected by both the District Court and the Sixth Circuit. As this Court held in *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177 (1974):

"We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action."

See also *Miller v. Mackey International, Inc.*, 452 F.2d 424, 428 (5th Cir. 1971).²⁸

Recognizing that repeated public statements have a substantial and cumulative impact upon the price of a security on the exchange over time, the courts have granted class certification in many cases covering periods far longer than the period involved here.²⁹ The impact of Basic's state-

²⁸ In determining whether the requirements of Federal Rule of Civil Procedure 23 have been met, or in defining a class, it is inappropriate for the court to attempt to determine which class members may ultimately prevail. See, e.g., *Senter v. General Motors Corp.*, 532 F.2d 511, 523 (6th Cir.), cert. denied, 429 U.S. 870 (1976); *Herrmann v. Atlantic Richfield Co.*, 65 F.R.D. 585, 590 (W.D. Pa. 1974).

²⁹ See, e.g., *Blackie*, 524 F.2d 891 (27-month class period); *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), cert. denied, 395 U.S. 177 (1969) (2½-year class period); *Hochschuler v. G.D. Searle & Co.*, 82 F.R.D. 339 (N.D. Ill. 1978) (2-year class period); *In re Home-Stake Production Company Securities Litigation*, 76 F.R.D. 351 (N.D. Okla. 1977) (9-year class period); *Cohen v. Uniroyal, Inc.*, 77 F.R.D. 685 (E.D. Pa. 1977) (3-year class period).

ments, and the damages that were suffered by persons who sold their shares, are issues for the trier of fact.³⁰

CONCLUSION

The Decision of the Sixth Circuit should be affirmed.

Respectfully submitted,

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June 16, 1987

³⁰ If respondents are able to establish that Basic's repeated public denials artificially caused Basic stock to trade at prices below the prices at which the shares would have traded had the true facts been disclosed, then class members who sold their shares at artificially depressed prices are entitled to recover the damages resulting from Basic's false and misleading statements. See *Affiliated Ute Citizens*, 406 U.S. at 155; *Rowe*, 650 F. Supp. at 1113; *Schlanger*, 555 F. Supp. at 537-38.

REPLY BRIEF

IN THE
Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust, and
RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR PETITIONERS

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-279

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust, and
RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR PETITIONERS**PRELIMINARY STATEMENT**

This is not an insider trading case.¹ Consequently, concerns such as those expressed by respondents (Resp. Br., p. 33 n. 12) and the Securities and Exchange Commission (SEC Br., pp. 10-13) about illegal trading profits by insiders have no bearing on the standard of materiality applicable here.

The SEC expressly concurs in petitioners' position that the Sixth Circuit's standard, which would require the disclosure of

¹ As the District Court stated, "There is no evidence in the record that Basic or any of the individual defendants made open market purchases of Basic stock during the period at issue." App. 27a. See also App. 32a n. 11, 110a.

the most insignificant and stale contacts in a no corporate developments statement, should be rejected. SEC Br., pp. 18-19. Although respondents assert that the Sixth Circuit correctly reversed the award of summary judgment, they make no effort to support that Court's standard of materiality.

If the Sixth Circuit's aberrant view is put aside, the issue in this disclosure case is which of two standards should govern the determination of whether a no corporate developments statement is materially misleading. Under the first, contacts with an outsider which might result in a merger need not be disclosed until an agreement in principle has been reached. Under the second, those contacts must be disclosed if they "created a significantly greater possibility of a value-affecting acquisition than investors had reason to expect on the basis of publicly available information." SEC Br., p. 19. The choice of the proper standard requires the weighing of competing policy considerations without regard to factors peculiar to insider trading cases.

Under either standard, the award of summary judgment by the District Court should be reinstated. Under the agreement in principle standard, petitioners' entitlement to such relief cannot be questioned. If this Court should decide, instead, to adopt the less precise standard advocated by the SEC, the District Court's decision still should be reinstated. It is clear from the record, as summarized in detail by the District Court, that when each of the three statements was issued, the contacts between Basic and C-E had not "created a significantly greater possibility of a value-affecting acquisition."²

With respect to the class certification issue, respondents and the SEC have failed to meet the arguments advanced in petitioners' brief for not applying the fraud on the market theory here to facilitate class certification. They merely repeat the unproven hypotheses invoked in other cases as though they are indisputable and applicable in every Rule 10b-5 case.

² In other words, as stated by the District Court (App. 100a), the contacts never reached the point of "negotiations which might imminently produce an agreement in principle."

I. THE DISTRICT COURT'S GRANT OF SUMMARY JUDGMENT SHOULD HAVE BEEN AFFIRMED

A. Absent Insider Trading, The Materiality Of Preliminary Merger Discussions Should Be Measured By The Agreement In Principle Standard

1. The Contrast Between The Disclosure Cases And The Insider Trading Cases

Respondents and the SEC contend that the agreement in principle standard should not be adopted with respect to no corporate developments statements because it would then become available as a defense to insiders who exploit undisclosed information for their own benefit, thereby permitting wrongdoers to escape liability. But no reason is given for the necessity of using the same standard in these two vastly different situations. On the contrary, disclosure requirements under the federal securities laws typically vary depending upon the surrounding circumstances.

In certain situations, it is generally agreed that disclosure of merger discussions is not required. Thus, both respondents (Resp. Br., p. 29) and the SEC (SEC Br., p. 7) concede that generally a corporation has no duty to disclose merger discussions, however important the information might be to investors. Similarly, where a company has issued statements in connection with the solicitation of tenders or the redemption of its own securities, claims that the company should have disclosed pending preliminary merger discussions in its statements have been rejected. *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982) (self-tender), and *Reiss v. Pan American World Airways*, 711 F.2d 11 (2d Cir. 1983) (call of debentures). Cf. *Flamm v. Eberstadt*, 814 F.2d 1169 (7th Cir. 1987), cert. denied, 56 U.S.L.W. 3246 (U.S. Oct. 5, 1987) (No. 87-191) (statements issued in opposition to a hostile tender offer did not need to refer to efforts to find a white knight). In these cases, the courts concluded that pending preliminary merger discussions did not have to be disclosed because they would not

be material until the parties had reached an agreement in principle.³

On the other hand, incipient merger discussions have been viewed as material where those privy to undisclosed information concerning those discussions acted to exploit that information. Thus, an insider who purchases shares either in a direct transaction with a seller or on the impersonal market, following which a merger previously under discussion is announced, is accountable for damages and subject to disgorgement and injunctive relief. See *Pet. Br.*, p. 25 nn. 17 & 18.⁴

³ Respondents contend that the standard of materiality applied in *Staffin* and *Reiss* should be limited on the ground that "the issue was whether defendants were under an affirmative duty to disclose merger discussions, not whether defendants were free to deny rumors of merger activity while they were in fact engaged in merger discussions." *Resp. Br.*, p. 40. This attempted distinction cannot be reconciled with the decisions themselves. *Staffin*, for example, expressly stated that there was a duty to disclose material information during the tender offer (672 F.2d at 1205) and then went on to rule that the preliminary merger negotiations were not material.

There is no dispute that both the elements of duty and materiality must be present to sustain a Rule 10b-5 claim. In other words, there is no actionable claim for a failure to disclose (i) material information when no duty to do so exists or (ii) information which is not material where there is a duty to disclose material information.

Under Rule 13e-4, 17 C.F.R. § 240.13e-4, promulgated under Section 13(e)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(e)(1), issuers which tender for their own securities must disseminate a statement on Schedule 13E-4, 17 C.F.R. § 240.13e-101. Pursuant to Item 3(b) of the Schedule, a description must be given of any "plans or proposals which relate to or would result in . . . [a]n extraordinary corporate transaction, such as a merger, reorganization or liquidation, involving the issuer or any of its subsidiaries". Recommendations in response to tender offers by others, however, must "state whether or not any negotiation is being undertaken or is underway . . . which relates to or would result in" such a transaction. See Item 7(a) of Schedule 14D-9, 17 C.F.R. § 240.14d-101 prescribed pursuant to Rule 14d-9, 17 C.F.R. § 240.14d-9, promulgated under Section 14(d)(4) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(d)(4).

⁴ See also *Jordan v. Duff and Phelps, Inc.*, 815 F.2d 429 (7th Cir.), petition for cert. filed, 56 U.S.L.W. 3116 (U.S. July 27, 1987) (No. 87-

Where insider trading is alleged, the determination of the materiality of preliminary merger discussions will depend upon whether factors extraneous to the discussions themselves are present. If an insider purchases with undisclosed information concerning the discussions, his action will be considered a subjective recognition of the significance of discussions even at the earliest stages and will bear heavily upon the determination of their materiality. But, absent insider trading, the failure to disclose discussions which have not reached an agreement in principle should not be actionable.⁵

2. Different Policy Considerations Require Different Rules In Insider Trading Cases And No Corporate Developments Statement Cases

No corporate developments statements should not be viewed as materially misleading unless the discussions have reached an agreement in principle. The conduct of responsible corporate management seeking to ensure disclosure of significant corporate developments, or the absence thereof, should not be measured by a standard developed to sanction an insider who seeks to appropriate a wrongful benefit through a breach of fiduciary duty. Absent trading, there is no sound reason why no corporate developments statements should be found materially misleading when, for example, the discussions either are at

183) (distinguishing *Flamm* and holding the agreement in principle standard inapplicable to a closely-held corporation acquiring stock from a departing employee); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), cert. denied, 419 U.S. 830 (1974) (a close corporation, like its officers, may not trade in its own securities without disclosing preliminary merger negotiations).

⁵ In addition, disclosure is also required "where the company is responsible for leaks into the market or where regulations promulgated by the Commission require disclosure." *SEC Br.*, p. 7 (footnotes omitted). No applicable SEC regulation required disclosure here. As to leaks, the District Court explicitly found that "[t]here is no evidence in the record of any leak of information about Basic and Combustion discussions during the 1977 and 1978 period of increased trading in Basic stock." App. 98a n. 57.

an early stage or have apparently been abandoned. Any other standard would impose sanctions on corporate managements which, with salutary motives, choose to speak, whereas, if they had chosen to remain silent under identical conditions, they would not be subject to claims for damages.⁶ As noted in *Flamm, supra*, 814 F.2d at 1175-78, the agreement in principle standard establishes a readily ascertainable point at which disclosure is required and avoids inhibiting negotiations by requiring early disclosure. See *Pet. Br.*, pp. 23-24.

Although the SEC concedes (*Br.*, p. 16) that "[c]lear-cut guides to conduct are desirable" and that the fixing of disclosure at a point where it will not stifle merger negotiations "is an important concern", it goes on to assert that these objectives must yield if they conflict with what the SEC views as other more important objectives. It states (*SEC Br.*, pp. 16, 18):

Any rule that makes a single event (such as the reaching of an agreement in principle) the conclusive determinant of materiality in all cases will either excuse some falsehoods about significant matters or impose liability on account of misstatements of trivial information, a result against which *Northway* cautioned.

* * *

No rule of law condones fraud simply so that other corporate goals might thereby be served. (footnotes omitted).

⁶ The anomaly of such a result was recognized by Judge Friendly in *Securities and Exchange Comm. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (concurring opinion), cert. denied, 394 U.S. 976 (1969):

If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former.

What the SEC overlooks is that no one will be misled by a no corporate developments statement issued prior to the reaching of an agreement in principle once the market understands generally that the statement does not rule out the possibility that merger discussions may be in progress.

In the SEC's view, if the agreement in principle standard of materiality were applicable to no corporate developments statements cases, this would, of necessity, "allow insider trading on highly significant information about pending acquisitions." *SEC Br.*, 15 n. 15. But, as previously shown, the courts have uniformly applied a lower standard of materiality in insider trading cases, even though this "make[s] the same facts material in some legal contexts but not others". *Id.* Whether these different standards fairly could be described as "skewing the definition of materiality" (*id.*), or merely fine-tuning it to fit the precise situations at issue, there is no reason why the SEC's concern about the problem of insider trading should lead to the abandonment of standards developed to govern corporate disclosure.

The disclosure requirements of the federal securities laws provide for dissemination of information to enable investors to make informed investment decisions. This general policy does not require that all information, however insignificant or important, must always be disclosed. There is sometimes a tension between the desire to keep investors informed and the attainment of results that are in the best interests of stockholders.

The determination of the materiality of information is a function of the resolution of these distinct policy considerations. Whether or not there is a duty to disclose depends upon the situation involved. If an insider is trading in the market, a duty to disclose arises to prevent his use of non-public information to secure a profit at the expense of other investors. This policy consideration supports the use of a lower standard of materiality in insider trading cases while, at the same time, different policy considerations support the use of the agreement in principle standard here.

**B. Even Under The Standard Proposed By The SEC,
None Of The Statements Issued By Basic Was
Materially Misleading As A Matter Of Law**

The SEC has recognized that

Not every conversation or other activity that might eventually lead to a merger is material. . . . The possibility of acquisition exists, in varying degrees, for many companies much of the time, and overtures unlikely to lead anywhere are common. SEC Br. p. 11 (footnote omitted).

In the SEC's view, information concerning preliminary merger negotiations becomes material at some uncertain point prior to the reaching of an agreement in principle. Its position is stated as follows (*Id.*, p. 12):

But if events not yet disclosed have significantly increased the possibility of an acquisition at a premium price (or on any terms that are likely to affect the value of an investment in the company's securities), that significantly increased possibility is material information even if no agreement on price and structure has been reached: it is obvious that a reasonable investor would attach importance to such a development. (footnote omitted).

This "significantly increased possibility"⁷ arises when

a target company and an acquiror have both exhibited serious interest in an acquisition . . . evidenced not only

⁷ The SEC's "significantly increased possibility" standard, which it sometimes has called the "probability/magnitude" standard (see Brief of the United States on petition for a writ of certiorari, pp. 8-9, 15), is substantially identical to the standard employed by the District Court, under which discussions reflecting "negotiations destined, with reasonable certainty, to become a merger agreement in principle" are material. App. 103a. The District Court recognized that there had to be evidence of bargaining on the terms of a proposed merger and noted that here there was no such evidence.

by their overt expressions but also by their conduct, including the time and resources devoted to the possible acquisition, the level in each company at which it is considered, the extent to which experts, such as outside counsel or investment bankers, are involved, and similar factors. *Id.*, p. 13.

The record in this case clearly shows that at the time each statement was issued, the undisclosed contacts did not reflect a "significantly increased possibility" of an acquisition. Thus, even under the SEC's standard, the District Court's award of summary judgment to petitioners should be reinstated.⁸

The determination of whether the failure to disclose the contacts between Basic and C-E rendered Basic's statements materially misleading under the SEC's standard requires an examination of the circumstances leading to the issuance of each of the three widely-separated statements, as well as the nature of the contacts themselves. The October 1977 statement was issued because of the impact of the unfounded Flintkote rumor on trading in Basic shares. The September and November 1978 statements were issued to advise the public of Basic's inability to discover a reason for unusual trading activity which took place during a brief period in late September 1978.

Although the SEC (Br. p. 14 n. 13) characterizes the District Court's standard as "a modified version of the *Staffin/Heublein* standard," the fact is that the SEC's "significantly increased possibility" standard and the District Court's "reasonable certainty" standard are no more than different expressions of the same principle.

⁸ At least as to the October 1977 statement, the SEC is apparently in agreement with this conclusion. Thus, it recognizes that the District Court's description of the events prior to the issuance of that statement would support a conclusion that although, like many companies at most times, Basic was a subject of some acquisition interest, events had not yet significantly increased the possibility that the company would be acquired. SEC Br., p. 20.

Although the SEC notes that the Sixth Circuit read the record differently, there is no evidence in the record which would support the Sixth Circuit's reading.

Contrary to the claim that the three statements were "issued for the very purpose of dispelling rumors in the marketplace that Basic was involved in ongoing merger discussions" (Resp. Br., pp. 2, 27), the only statement issued to dispel a rumor was the October 1977 statement. Significantly, that rumor had nothing to do with C-E.⁹

The accuracy of so much of the October 1977 statement as denied that Basic was engaged in merger negotiations cannot be disputed. The contacts between Basic and C-E as of that time were of the most preliminary kind and thus could not be viewed as having significantly increased the possibility of an acquisition by C-E. Kelly had indicated an interest in encouraging C-E to pursue contacts with Basic. However, Basic was merely a passive listener and took no steps to encourage Kelly to pursue his interest. The District Court accordingly concluded, after examining the record in the light most favorable to respondents, that no genuine issue of material fact existed as to the accuracy of the October 1977 statement. App. 65a.

No reference to merger discussions appears in either the September or November 1978 statements. Both deny a present or pending company development that would explain or account for unusual trading activity. The September 1978 statement was issued at the request of the NYSE.¹⁰ The November 1978 statement merely repeated the substance of the September 1978 statement to ensure that all Basic shareholders became aware of the company's inability to explain the September trading activity. Neither was issued to dispel rumors of merger

⁹ The rumor related to a possible tender offer by Flintkote for Basic. Although it had no factual foundation, the Flintkote rumor apparently was the cause of unusual trading activity in Basic shares.

¹⁰ The September 1978 statement was the only one issued in response to an NYSE inquiry. Respondents' description of that activity (Br., pp. 20-21) seeks to suggest that it was related to the contacts between Basic and C-E. But this is inconsistent with the fact that no such contacts had occurred for more than two months prior to the issuance of that statement and ignores "the undisputed fact in the record that none of the rumors of companies interested in acquiring Basic at any time linked Combustion Engineering to Basic." App. 96a-97a.

discussions. Indeed, the record contains no indication that there were any such rumors to dispel.

As is set forth in detail in the decision of the District Court, but referred to only in conclusory fashion by the Sixth Circuit, the meetings and telephone conversations during which Basic and C-E discussed a possible acquisition in the period between mid-September 1976 and mid-November 1978 (shortly following the issuance of the last statement) were relatively few and inconsequential. The following table summarizes meetings and telephone conversations between C-E and Basic concerning a possible acquisition during that period.¹¹

Date	Participants and Subject Matter
<i>Fall 1976</i> [App. 3a-4a, 45a; JA 81-86, 123-27, 335-36, 343, 348]	Kelly discusses a possible acquisition of Basic by C-E. Muller states Basic is not interested and prefers to remain independent.
<i>January 1977</i> [App. 4a, 46a-47a; JA 228-30, 345-46, 348]	Kelly states that C-E is "very interested in Basic" but is "not going to make an unfriendly tender offer." Kelly suggests that Muller and Ludwig meet with C-E's president, but no meeting is held.
<i>October 1977</i> [App. 5a, 53a-55a, 61a; JA 113-14, 128-29, 146-47, 232-33, 331, 358]	Kelly describes C-E and sketches an organization chart to show where Basic would fit in C-E's structure if C-E ever acquired Basic. ¹²
<i>November 1977</i> [App. 67a-68a; JA 233-34, 331]	Kelly speaks with Muller by telephone and asks whether Basic is ready to merge. Muller replies "not yet".

¹¹ References are to discussions of these contacts in the decisions below, in deposition testimony and in documentary exhibits.

¹² The October 1977 statement is issued nine days later.

Date	Participants and Subject Matter
February 1978 [App. 69a-70a; JA 130, 156-60, 178-79, 236-37, 263-64, 331, 371, 480]	Kelly meets with Muller and Ludwig. They discuss a possible acquisition by Basic of C-E Refractories, but not Kelly's interest in having C-E acquire Basic.
March 1978 [App. 70a-72a, JA 10, 67-69, 174, 332, 482]	Insley, Kelly's subordinate, meets with Ludwig, Thomas and Arnolt and discusses Basic's interest in C-E Refractories, but not Kelly's interest in having C-E acquire Basic.
June and July 1978 [App. 6a, 76a-79a, 81a-83a, 86a-87a, 100a; JA 93, 104-07, 115-16, 118-21, 131-32, 156, 246-60, 268-73, 332-34, 382, 388, 391-400, 487, 495]	Kelly meets with Muller, Ludwig and Caito. They propose that Basic purchase C-E Refractories for \$26 million. Kelly rejects that price and renews his interest in having C-E acquire Basic, suggesting that he could recommend \$28 per share. Muller states that price is "too low." Kelly suggests having C-E specify its "best figure" but Muller asks him to "hold off." Thereafter, during July, Muller and Kelly speak by telephone on various occasions. Kelly indicates he will prepare an informal offer, advises against public disclosure and suggests that counsel meet to discuss the antitrust implications of any C-E and Basic combination, but no meeting is held. ¹³

¹³ The September 1978 statement is issued two months later; the November 1978 statement six weeks after that. Kelly does not renew the subject of his interest in having C-E acquire Basic until late November, more than four months after his last July conversation with Muller.

Both the nature of these contacts and the substantial periods during which there were no contacts are inconsistent with a conclusion that, at the time any of the statements was issued, there was a "significantly increased possibility" of an acquisition by C-E.

Respondents seek to meet the SEC's standard by characterizing events during 1977 and 1978 in a way which purports to show that senior management of both companies, as well as their investment bankers and Basic's outside counsel, devoted substantial time and resources to C-E's possible acquisition of Basic. However, the record concerning these events does not raise an issue of fact sufficient to suggest a "significantly increased possibility of an acquisition" required by the SEC's standard. The District Court reviewed the record and properly declined to draw the speculative inferences sought by respondents. See also Pet. Br., pp. 32-33. Its review was consistent with its responsibility to determine whether "the factual context renders respondents' claims implausible." *Matsushita Electric Industrial Co., Ltd. v. Zenith Radio Corp.*, ___ U.S. ___, 106 S. Ct. 1348, 1356 (1986). The Sixth Circuit, by contrast, adopted a version of facts which is at variance with that of the District Court, is contradicted by the undisputed record and, quite simply, is utterly implausible.

II. THE COURTS BELOW IMPROPERLY CERTIFIED THIS CASE AS A CLASS ACTION

A. The Direct Transaction Cases Do Not Support The Fraud On The Market Theory

The application of the fraud on the market theory by the lower courts reflects the continuation of a process begun by the Ninth Circuit in *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). *Blackie* and the decisions following it have effectively eliminated the element of reliance or transaction causation from the private right of action implied under Rule 10b-5. This result is claimed to be supported by the economic soundness of the efficient market

hypothesis from which the fraud on the market theory springs and by the societal benefits derived from freeing Rule 10b-5 from the limitations of its common law fraud origins.

The lower courts have created the fraud on the market theory by unduly expanding the limited presumption of reliance approved in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). That case recognized the inherent difficulty in proving reliance when those who sell securities claim that the defendant purchasers cheated them by failing to disclose material information. In approving a presumption of reliance designed to overcome that difficulty, *Affiliated Ute* concluded that defendants should bear the burden of showing that plaintiffs would have entered into the transactions even if the withheld information had been made known. In creating a presumption of reliance on the integrity of the market, the courts have strayed far beyond the specific rationale of *Affiliated Ute*.

Despite claims by its proponents that the fraud on the market theory has been uniformly embraced, the fact is that, in some cases involving statements claimed to be materially misleading, such as this, the theory has been rejected. Thus, in *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987), petition for cert. filed, 56 U.S.L.W. 3171 (U.S. Aug. 21, 1987) (No. 87-303), the Court of Appeals reaffirmed its holding in *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (*en banc*), cert. denied, 459 U.S. 1102 (1983), that

any fraud on the market claim under subsection (2) is barred by plaintiff's failure to allege that she read or relied on any of the documents now claimed to have misrepresented the financial condition of Docutel. As to claims under Rule 10b-5(2), therefore, we affirm the district court's dismissal of the complaint. 817 F.2d at 363.¹⁴

¹⁴ Because the Court concluded that the complaint also could be read to allege nondisclosure claims, as in *Affiliated Ute*, it reversed the

Docutel/Olivetti shows that the fraud on the market theory should not apply to impersonal market cases arising from allegedly misleading statements because those cases do not present the problems of proof addressed by the *Affiliated Ute* presumption. Plaintiffs face no difficulty in proving actual reliance upon misleading statements. On the other hand, defendants have little, if any, ability to rebut the presumption. Rebuttal would require a showing that persons with whom defendants had no contact would have made the same investment decisions if they had been aware of all the facts.

Here, a presumption of reliance on the integrity of the market was applied despite the lack of any logical basis to assume that all persons who sold Basic shares at all times throughout the 14-month class period would not have done so

dismissal of claims under Rule 10b-5(1) and (3). Although the amended complaint here (R. 21 ¶ 41) refers to subsection (1) of Rule 10b-5 as well as to subsection (2), respondents cannot argue that their claims fall within subsection (1). Had they characterized count 1 of the amended complaint as a nondisclosure claim, it would have been dismissed. See App. 131a-33a and the District Court's July 18, 1980 decision in which it refused to dismiss count 1 and wrote (R. 31 at 6):

The allegations of the amended complaint distinguish this case from *Fridrich v. Bradford*, 54[2] F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977), relied upon by Basic. In this case, Basic is not claimed to have simply kept information to itself; rather, it is alleged to have made statements that were in one case false and in two cases misleading because they allegedly gave the false or misleading impression that certain corporate developments were not taking place when in fact they were. Therefore, this is not a case in which the defendant simply refused to disclose or comment.

See also the District Court's October 14, 1980 decision refusing reconsideration (R. 37 at 3):

[P]lainly construed, the amended complaint's Count 1 allegations are not reasonably characterized as claims of "pure non-disclosure." They clearly assert corporate disclosures that were either knowingly and materially false, or misleading due to a material omission. Basic's attempt to mold plaintiffs' allegations into a factual form applicable to *Fridrich* is unpersuasive. (emphasis in original).

had they known of the status of the contacts between C-E and Basic when they decided to sell.

B. The Fraud On The Market Theory Represents A Significant Departure From The Origins Of Section 10(b) As A Fraud Statute

Arguments as to benefits which might be derived from expansion of Section 10(b) beyond the traditional parameters of fraud cannot be reconciled with decisions by this Court reconfirming the vitality of the relationship between Section 10(b) and common law fraud. While there may be circumstances where it is appropriate for courts interpreting rights provided by statute to give effect to the changing environment in which the statute operates, that same principle of construction should not be so freely applied to rights implied by the courts. These should adhere more closely to their origins. Arguments seeking to expand their scope to serve the objectives of particular interest groups should be addressed to Congress and not to the courts.

If, for example, reliance or transaction causation should be abandoned as an element of an implied right of action under Section 10(b), it should be done by Congress. After appropriate study, Congress can enact statutes consistent with its view of the manner in which the rights of participants in the securities marketplace should be protected.¹⁵ Advocates of the fraud on the market theory lose sight of the limitations on judicial law-making and the fact that courts should not usurp the function of Congress, first by creating implied rights to relief and then by expanding them in a manner which radically alters the philosophy and policy of the underlying legislation.

¹⁵ See, e.g., the recently enacted § 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d), empowering the SEC to seek a civil penalty of three times the profit gained or loss avoided from those who engage in insider trading.

The statutory scheme of the Securities Exchange Act of 1934 was directed, in substantial part, toward the elimination of acts of direct or indirect fraud. Application of the fraud on the market theory, especially to cases such as this one, serves no purpose consistent with the proper functioning of the federal securities laws. Rather, it substitutes a form of investor insurance for anti-fraud protections.

C. There Is No Logical Basis To Apply The Fraud On the Market Theory In This Case

The irrationality of the fraud on the market theory is particularly apparent when it is advanced as a basis for class certification in an action such as this one. Where, as here, no corporate developments statements are challenged as misleading because they fail to refer to contingent future possibilities, the undisclosed information itself relates to matters so inchoate that judgments as to whether any market impact likely to flow therefrom continued throughout a lengthy period are speculative and conjectural at best.

There is no logical reason to assume that the disclosure of the contacts between C-E and Basic at the time each statement was issued would have had any market impact, or one lasting more than a brief period. For example, the price at which Basic shares traded in August 1978—ten months after the October 1977 statement—cannot reasonably be believed to have reflected any continuing impact from the failure of the October 1977 statement to mention the previous contacts between C-E and Basic. Similarly, there is no logical reason to assume that the members of the putative class who reached decisions to sell throughout the 14-month class period would have reached different decisions had they known of the sporadic visits by Kelly to Basic or of the discussions which took place.

When the fraud on the market theory undermines the analysis required by the predominance requirement of Rule 23, it leads to the widespread class certification of actions which traditionally could be pursued only on an individual basis. Outside the class context, such as when the fraud on the

market theory is relied upon in opposition to motions to dismiss or for summary judgment, defendants have a better opportunity to seek to show why the theory is inconsistent with the allegations of the complaint or the facts in the record.¹⁶

Putative class representatives, such as respondents, should not be permitted to invoke the fraud on the market theory while, at the same time, arguing that courts may not make any preliminary inquiry into the claimed impact on the market. See, e.g., Resp. Br., p. 54. By seeking the benefit of the presumption, respondents necessarily invite judicial scrutiny of the circumstances in which it is invoked. Any other result would permit serious abuses which a right to relief after trial would be inadequate to correct.

CONCLUSION

In C-E's tender offer for Basic's shares, it was stated that

From time to time, since October 1976, representatives of C-E have had meetings with representatives of [Basic] concerning the possible acquisition of [Basic] by C-E or an affiliate of C-E. JA 417.

Apparently, that statement encouraged respondents to commence this action. Following the completion of extensive discovery, the District Court properly recognized that respondents' speculation that active merger negotiations had been in progress for more than two years was wholly unfounded. The Sixth Circuit's reversal of the award of summary judgment to petitioners reflects a misreading of both the law and of the record before it.

¹⁶ Both in the amended complaint and at their depositions, respondents specifically claimed that they sold their Basic shares in actual reliance on one or more of Basic's statements. See, e.g., R. 21 ¶¶ 26-29 and 34-35. As a result, when the fraud on the market theory subsequently was invoked to facilitate class certification, petitioners had not had any prior opportunity to test its premises by a motion directed to the pleadings or discovery directed to respondents.

A claim that no corporate developments statements failed to disclose preliminary discussions concerning an acquisition which is subsequently agreed to may properly be dismissed on a motion for summary judgment where, as here, no one acted upon or sought to benefit in any way from knowledge of the discussions or disclosed such information to others who sought to benefit therefrom.

The District Court's award of summary judgment should be reinstated in its entirety. If it is not, the orders of the courts below permitting this case to proceed as a class action should be reversed. Claims for damages on behalf of all sellers during a 14-month period arising from sales in the impersonal market, which rest upon statements claimed to be misleading because they failed to refer to contingent future events, should not receive class certification.

At a minimum, summary judgment for petitioners should be reinstated as to the October 1977 statement and, if the class certification order is not independently vacated in its entirety as a matter of law, the class period should be limited to September 25, 1978 through December 15, 1978.

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AMICUS CURIAE

BRIEF

In the Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ET AL., PETITIONERS

v.

MAX L. LEVINSON, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

**BRIEF FOR THE
SECURITIES AND EXCHANGE COMMISSION
AS AMICUS CURIAE**

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QUESTIONS PRESENTED

1. Whether the court of appeals employed the correct standard for determining that a corporation's merger negotiations were material to investors, for purposes of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

2. Whether a plaintiff who traded in a corporation's stock on a securities exchange after the issuance of a materially false statement by the corporation is entitled to a rebuttable presumption that he relied on the market price in so trading.

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In the Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-279

BASIC INCORPORATED, ET AL., PETITIONERS

v.

MAX L. LEVINSON, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUITBRIEF FOR THE
SECURITIES AND EXCHANGE COMMISSION
AS AMICUS CURIAEINTEREST OF THE
SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission is the agency responsible for the administration and enforcement of the federal securities laws. This case presents two important questions arising under the antifraud provisions of those laws. The first is the proper standard for assessing the materiality of corporate merger negotiations and other pre-merger activity. In this case, the issue arises in the context of a private damage action against a corporation that was a party to a proposed merger. The same question also arises in other fraud cases, such as private damage actions alleging unlawful insider trading by persons in possession of material, non-public information about merger activity, and in enforcement actions brought by the SEC.

The second question is whether a plaintiff who alleges that a corporate misstatement constituted a "fraud on the market" in which he traded is entitled to a rebuttable

presumption of reliance. Under the fraud on the market theory, which has been adopted by every court (including eight courts of appeals) to address it, it is presumed that any material corporate misstatement was reflected in the market price of the security and that investors, in making decisions to trade, relied on the integrity of the market price and thus indirectly relied on the misstatement. While the issue does not arise in Commission actions, in which reliance need not be shown, it is often important in private actions to enforce the securities laws, which are a "necessary supplement" to the Commission's enforcement actions. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

STATEMENT

1. Respondents, former shareholders of Basic Incorporated (Basic), brought this class action against petitioners—the corporation and certain of its officers and directors—alleging that petitioners issued three false or misleading public statements in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. Respondents claim that they sold shares of Basic stock in a market artificially affected by these statements (Pet. App. 2a).

Following unusual trading activity in the company's stock, Basic released a public statement on October 21, 1977, reciting that "the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger" (Pet. App. 5a). Respondents claim that when Basic issued that public statement the company was in fact engaged in merger negotiations with Combustion Engineering, Inc. (Combustion), which eventually acquired Basic (see *id.* at 4a-5a). The second and third allegedly false public statements were made on September 25, 1978, and November 6, 1978. On both occasions, Basic announced that its management was "unaware of any present or pending corporate development[s]" that would account for a recent upsurge in

trading activity in Basic stock. Respondents contend that these statements were false or misleading because Basic in fact continued to engage in merger negotiations with Combustion (see *id.* at 5a-7a). On December 20, 1978, Basic announced its approval of a tender offer by Combustion to acquire all of Basic's outstanding shares at a price of \$46 per share (*id.* at 22a).

The respondent class consists of persons who sold shares of Basic stock on the New York Stock Exchange on various dates between October 21, 1977 and December 15, 1978, allegedly as a result of one or more of the three statements, at prices allegedly affected by the statements and substantially below \$46. The district court certified the class after determining that common issues predominated over individual issues (Pet. App. 119a, 127a). An important factor in this determination was the court's conclusion that under the "fraud on the market theory" reliance by each class member on the company's statements could be presumed and that there was no need for each class member to prove subjective reliance (*id.* at 118a).

The district court granted summary judgment for the defendants. It found (see Pet. App. 9a) that Basic's first statement on October 21, 1977 was not false or misleading because there were no negotiations occurring at that time, and that the second (September 25, 1978) and third (November 6, 1978) statements, although made while negotiations were occurring, were not materially false or misleading because the negotiations were not "destined with reasonable certainty, to become a merger agreement in principle" (*id.* at 103a). In so ruling, the court relied on a modified version of the test for the materiality of merger negotiations announced by the Third Circuit in *Staffin v. Greenberg*, 672 F.2d 1196 (1982). Under that test, as subsequently reaffirmed and refined by the Third Circuit in *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (1984), cert. denied, 469 U.S. 1215 (1985), merger negotiations are not material until the parties reach an agreement in principle (defined as agreement on price and structure).

2. The Sixth Circuit reversed, concluding that all three of the challenged statements were false or misleading and expressly disagreeing with the Third Circuit's test for materiality. The court of appeals held that, at least where false or misleading corporate statements (rather than a mere failure to disclose) are involved, merger negotiations need not reach an agreement in principle before they become material (Pet. App. 13a-15a). With respect to the negotiations here, the court stated that it was "inconceivable" that Basic stockholders would not find the fact that discussions were occurring between Combustion and Basic, in light of Basic's statements, to be important and, therefore, material to making normal reasonable investment decisions" (*id.* at 13a). The court of appeals added that where, as here, a company chooses to make public statements denying corporate developments, events "that might not have been material in absence of the denial are material because they make the statement made untrue" (*id.* at 13a-15a).

As to class certification, the Sixth Circuit agreed with the district court that under the fraud on the market theory respondents were entitled to a presumption of reliance, that common class issues therefore predominated over individual issues, and that class certification was appropriate (Pet. App. 19a).

SUMMARY OF ARGUMENT

1. Except in certain limited circumstances, a company has no affirmative duty to disclose ongoing merger negotiations. If, however, a company chooses to speak publicly, it must not misstate a "material" fact or omit a "material" fact if the omission makes the statement misleading. A fact is "material" if there is a "substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision about the company's stock. *TSC Industries, Inc. v. Northway, Inc.*,

426 U.S. 438, 449 (1976). Where the fact is the possibility of a future, uncertain event, such as a possible merger, its materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in the light of the totality of the company['s] activity" (*SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)). Under this standard, discussions and other activities looking toward a possible merger (merger activity) may be material to investors before there is an agreement in-principle to merge. Tentative overtures or inquiries will often be immaterial. But if negotiations or other corporate activity not yet disclosed has significantly increased the possibility of a merger that can be expected to affect the value of an investment in the company's securities, that significantly increased possibility will normally be material information.

The courts that have held that merger activity is not material until an "agreement in principle" is reached have done so not because they view all prior merger activity as unimportant to a reasonable investor but because of three concerns about the consequences of earlier disclosure. One concern, that disclosure prior to an agreement in principle will inevitably be misleading, is unfounded: corporate officials and their advisers should be capable of accurately describing the situation without understating or overstating the likelihood that a merger will occur. A second concern, that corporations need a "bright line" test of when merger activity becomes material, also does not warrant use of the agreement in principle standard. Inherent in the *Northway* "reasonable person" standard of materiality is the understanding that many decisions as to materiality will require the exercise of judgment by persons responsible for corporate disclosure; any bright line rule would inevitably be overinclusive or underinclusive. The third concern, that accurate disclosure may affect or scuttle some negotiations, is an im-

portant one, but it does not warrant the conclusion that information is not material prior to an agreement in principle. In most circumstances, the company has the option of remaining silent or declining to comment. Where disclosure is required, many of the details may often be kept secret. In any event, concerns about affecting the course of negotiations do not justify allowing corporations to make materially false or misleading statements on which investors may rely.

2. The courts below properly applied a presumption of reliance by a plaintiff who alleges that corporate misstatements constituted a "fraud on the market." The fraud on the market theory, which has been adopted by all eight courts of appeals that have considered the matter, consists of two rebuttable presumptions: that all information, including corporate misstatements, disseminated into an active secondary market is reflected in the price of securities traded in that market; and that investors who buy and sell after a misstatement has been made rely on the integrity of the market price and are therefore relying indirectly on the misstatement. Under this theory, direct reliance on a corporate misstatement need not be proved.

The fraud on the market theory is amply supported by extensive empirical evidence about the functioning of capital markets and by common-sense observations about investor behavior. The presumption of reliance promotes judicial efficiency; it is consistent with basic assumptions regarding the operation of capital markets that underlie the federal securities laws; it promotes the integrity of those markets by facilitating the prosecution of private securities fraud actions; and it eliminates the need for investors to meet often impractical evidentiary burdens.

ARGUMENT

I. THE MATERIALITY OF ONGOING MERGER ACTIVITY MUST BE JUDGED ON THE FACTS OF EACH CASE, TAKING INTO ACCOUNT THE SIGNIFICANCE THE MERGER WOULD HAVE FOR THE COMPANY AND THE LIKELIHOOD OF ITS OCCURRENCE

A. Ongoing Merger Discussions May Be Material Before An Agreement To Merge Is Reached

1. As the court below recognized, a company generally has no affirmative duty under the federal securities laws to disclose ongoing merger activity and may elect to remain silent even if the information would be material to investors (see Pet. App. 9a). Disclosure is required only in certain limited circumstances, such as where a company is trading in its own stock, and thus has a duty to disclose all material information,¹ where the company is responsible for leaks into the market² or where regulations promulgated by the Commission require disclosure.³

¹ See, e.g., *Jordan v. Duff & Phelps, Inc.*, No. 86-1611 (7th Cir. Mar. 17, 1987), slip op. 10; *Staffin v. Greenberg*, 672 F.2d 1196, 1205 (3d Cir. 1982); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), cert. denied, 419 U.S. 830 (1974). See generally *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

² See, e.g., *State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981).

³ For example, a company is required to disclose on Schedule 14D-9 merger negotiations undertaken in response to a tender offer. 17 C.F.R. 240.14d-101, Item 7. See *In re Revlon, Inc.*, Exchange Act Release No. 23,320, 35 S.E.C. Dkt. 1541, 1550-1552 (June 16, 1986). See also Item 3(b) of Schedule 14D-1, 17 C.F.R. 240.14d-100; Item 3(b) of Schedule 13E-3, 17 C.F.R. 240.13e-100; Item 504 of Regulation S-K, Instruction 6, 17 C.F.R. 229.504. The fact that a Commission form or schedule requires disclosure does not necessarily mean that the information would be material in the absence of that disclosure requirement.

But it is a different situation when a company chooses to make "assertions . . . in a manner reasonably calculated to influence the investing public." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). Then the company violates Rule 10b-5 when the information it disseminates contains a material misstatement or omits to state a material fact whose omission renders the statement misleading. *Ibid.*

2. In general, a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if it would have "significantly altered the 'total mix' of information made available" to the shareholder. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (footnote omitted).⁴ Where a corporate development is certain, its significance to investors depends on its importance to the company's fortunes. But where a potential future event is not certain to occur, as is the case with a possible merger, the assessment of materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company['s] activity." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 849. Accord, *SEC v. MacDonald*, 699 F.2d 47, 50 (1st Cir. 1983); *SEC v. Mize*, 615 F.2d 1046, 1051 (5th Cir.), cert. denied, 449 U.S. 901 (1980); *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 887-888 (2d Cir. 1972). Ordinarily, neither the probability nor the magnitude of a prospective event can be

⁴ *Northway* arose under the proxy solicitation provisions of the Securities Exchange Act, but subsequent decisions have applied its test of materiality in cases arising under Section 10(b) and Rule 10b-5, involving purchases and sales of securities. See, e.g., *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 466 n.4 (7th Cir.), cert. denied, 454 U.S. 835 (1981); *Goldberg v. Meridor*, 567 F.2d 209, 218 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978); *Healey v. Catalyst Recovery of Pennsylvania, Inc.*, 616 F.2d 641, 647 (3d Cir. 1980).

stated with mathematical precision. See *Northway*, 426 U.S. at 448. But imprecision is inherent in the *Northway* standard of materiality, of which the probability/magnitude formula is a part. See *id.* at 450 ("[t]he determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him.").

3. In accordance with these principles, the materiality of merger discussions must be judged in each case on its facts. For example, in *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974), the court, in considering the materiality of merger discussions, refused to "establish a rule as to when information . . . becomes material" because such a determination must be made "according to the fact pattern of each specific transaction." *Id.* at 1306 (quoting *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d at 888). Accord, *Grigsby v. CMI Corp.*, 765 F.2d 1369, 1373, 9th Cir. 1985) ("The materiality of preliminary merger negotiations depends on the facts of the case.").

A merger is often such a significant event that, even where agreement is far from certain, the existence of merger activity may be material to investors.⁵ In *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976)—a case in which "embryonic" merger talks were held to be material—Judge Friendly stated that since "a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death," negotiations "can become material at an earlier stage than would be the case as regards lesser trans-

⁵ See, e.g., Dennis & McConnell, *Corporate Mergers and Security Returns*, 16 J. Fin. Econ. 143, 154 (1986) (average increase of 8.56% in price of acquired companies' shares in two-day period surrounding announcement of a merger); Jensen & Ruback, *The Market for Corporate Control*, 11 J. Fin. Econ. 5, 7-8 (1983) (average gain to target company shareholders of 20%); *Economic Report of the President 197* (1985) ("recent studies find average gains [from successful takeovers] in the range of 16 to 34 percent of the value of the target's shares").

actions—and this even though the mortality rate of mergers in such formative states is doubtless high.”⁶

The possibility of a merger may have an immediate importance to investors in the company's securities even if no merger ultimately takes place. For example, in *SEC v. Gaspar*, [1984-1985] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. 1985), the company's announcement of preliminary (though ultimately unsuccessful) merger talks sent the stock's price soaring by more than 40% on greatly increased volume.⁷ And, as recent events illus-

⁶ See also *SEC v. Shapiro*, 494 F.2d 1301, 1306-1307 (2d Cir. 1974); *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 368 (2d Cir.), cert. denied, 414 U.S. 910 (1973); *Holmes v. Bateson*, 583 F.2d 542, 558 (1st Cir. 1978) (merger negotiations that had not yet reached the point of discussing terms were nonetheless material); *Rogen v. Ilikon Corp.*, 361 F.2d 260, 266 (1st Cir. 1966) (“[e]ven with the possibility of [their] collapse,” negotiations could be material); *Dungan v. Colt Industries, Inc.*, 532 F. Supp. 832, 837 (N.D. Ill. 1982) (fact that the defendants were seriously exploring the sale of their company was material); *American General Insurance Co. v. Equitable General Corp.*, 493 F. Supp. 721, 744-745 (E.D. Va. 1980) (merger negotiations were material four months before agreement in principle was reached); *Levin v. Marder*, 343 F. Supp. 1050, 1058 (W.D. Pa. 1972) (“‘preliminary proposal’ of merger ‘may well be material’”); *Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128, 131-132 (S.D.N.Y. 1984) (“no corporate developments” statement issued by a company in the face of unusually heavy market activity in its stock could be materially false or misleading in that it failed to disclose pending merger negotiations that had not reached the point of agreement); *In re Carnation Corp.*, Exchange Act Release No. 22,214, 33 S.E.C. Dkt. 1025, 1031-1034 (July 8, 1985) (materially misleading to issue two “no corporate developments” statements in response to unusual market activity at a time when the company was engaged in preliminary merger discussions that were far from certain to result in an agreement).

⁷ See also Mikkelsen & Ruback, *An Empirical Analysis of the Interfirm Equity Investment Process*, 14 J. Fin. Econ. 523, 535 (1985) (finding an average 7.74% increase in stock price following Commission filings by persons who acquire 5% or more of a company's stock and indicate that they are considering acquiring control, but only 3.24% increase where investment intent only was expressed). Other studies show a consistent price rise in the poten-

trate, enormous illegal profits may be obtained by insiders privy to early merger discussions and by their tippees who trade in the target's stock before an agreement in principle has been reached.⁸

Not every conversation or other activity that might eventually lead to a merger is material. As this Court stated in *Northway*, “[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good” (426 U.S. at 448). The possibility of acquisition exists, in varying degrees, for many companies much of the time, and overtures unlikely

tial target's securities over a substantial period leading up to the day of the public announcement of a merger or merger negotiations; this is presumably due either to illegal trading by those with access to information about the merger activity, or legal trading by persons trading on educated speculation or rumors about a possible merger, or both. See Office of the Chief Economist, SEC, *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?* 17-20, 27-29, Table 7 (Feb. 24, 1987); Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. Fin. 855 (1981).

⁸ See, e.g., *SEC v. Boesky*, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986), discussed in Lit. Release No. 11,288, 37 S.E.C. Dkt. 78 (Dec. 2, 1986); *SEC v. Levine*, No. 86 Civ. 3726 (S.D.N.Y. May 12, 1986), discussed in Lit. Release No. 11,095, 35 S.E.C. Dkt. 1212 May 27, 1986; *SEC v. Katz*, No. 86 Civ. 6,088 (S.D.N.Y., filed Aug. 7, 1986), discussed in Lit. Release No. 11,185, 36 S.E.C. Dkt. 448 (Aug. 19, 1986); *SEC v. Thayer*, No. CA-3-84-0471-R (N.D. Tex. May 7, 1985), discussed in Lit. Release No. 10,746, 33 S.E.C. Dkt. 74 (May 21, 1985); *SEC v. Gaspar*, [1984-1985] Fed. Sec. L. Rep. (CCH) ¶ 92,004; *SEC v. Siegel*, No. 87 Civ. 0963 (S.D.N.Y., filed Feb. 13, 1987), discussed in Lit. Release No. 11,354, 37 S.E.C. Dkt. 1276 (Mar. 3, 1987). One commentator has noted (Olson, *Revealing Merger Talks: When, How Are Critical*, Legal Times, Oct. 14, 1985, at 22 (emphasis in original)):

As market activity based on acquisition rumors in case after case has shown, preliminary merger or takeover discussions are significant to investors in the target's securities and no amount of well-intentioned judicial rationalization in the search for bright-line rules can make that simple fact of materiality disappear.

to lead anywhere are common.⁹ But if events not yet disclosed have significantly increased the possibility of an acquisition at a premium price (or on any terms that are likely to affect the value of an investment in the company's securities), that significantly increased possibility is material information even if no agreement on price and structure has been reached: it is obvious that a reasonable investor would attach importance to such a development.¹⁰ The willingness of securities professionals to spend enormous sums to trade while in possession of information about early merger activity is ample evidence of the information's significance.¹¹

⁹ See, e.g., *Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075, 1085 (5th Cir. 1970), in which the court held immaterial a "unilateral offer to negotiate" made by a large shareholder of the potential acquiror that was repudiated two days later by the potential target's board, was never acknowledged by the potential target and "never got off the ground". See also *List v. Fashion Park, Inc.*, 340 F.2d 457, 464 (2d Cir.), cert. denied, 382 U.S. 811 (1965) (president of company knew nothing more than the name of a potential purchaser); *Bucher v. Shumway*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,142, at 96,302 (S.D.N.Y. Oct. 11, 1979) ("mere overtures or inquiries"), aff'd without opinion, 622 F.2d 572 (2d Cir.), cert. denied, 449 U.S. 841 (1980); *Berman v. Gerber Products Co.*, 454 F. Supp. 1310, 1316, 1318 (W.D. Mich. 1978) ("mere overtures"); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 65 (D.N.J. 1974) ("casual inquiry").

¹⁰ The stage at which merger activity becomes material depends in part on the likelihood of a premium price or other effect on value. For example, the effect of acquisitions on the prices of securities of acquiring companies, which generally are larger than acquired companies, is less certain. See, e.g., Jensen & Ruback, *The Market for Corporate Control*, 11 J. Fin. Econ. 5, 16-17 (1983); Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. Fin. Econ. 105, 134-135 (1980). Thus, merger activity might become material to investors trading in the potential acquiror's stock at a later stage than to investors in the potential target.

¹¹ For example, in one case recently brought by the Commission, an investment banker retained by the Carnation Company was alleged to have tipped an arbitrageur about a possible friendly

When a target company and an acquiror have both exhibited serious interest in an acquisition, there is ordinarily a significantly increased possibility that it will occur. The degree of interest of the target company and the potential acquiror is of course evidenced not only by their overt expressions but also by their conduct, including the time and resources devoted to the possible acquisition, the level in each company at which it is considered, the extent to which experts, such as outside counsel or investment bankers, are involved, and similar factors. An agreement on price and structure is surely a sufficient, but not a necessary, indicator of enough mutual interest to show that the possibility of a consummated transaction has been significantly increased.

There will also be instances where merger activity is material before the target has expressed any interest. In appropriate circumstances, the mere fact that an offer is to be made can be material. Some offers may be so attractive that they are very unlikely to be refused. In addition, friendly offers are commonly a prelude to hostile tender offers (see 1 M. Lipton & E. Steinberger, *Takeovers & Freezeouts* § 6.04[1], at 6-47 (1986)), the materiality of which is beyond doubt.¹² If it has received

takeover of Carnation by Nestle Corporation. The tipping occurred over a period three to five months before an agreement in principle was reached. The arbitrageur purchased 1.7 million shares of Carnation common stock and realized a profit of approximately \$28.3 million after the merger was announced. See *SEC v. Siegel*, No. 87 Civ. 0963 (S.D.N.Y., filed Feb. 13, 1987), discussed in Lit. Release No. 11,354 37 S.E.C. Dkt. 1276 (Mar. 3, 1987). At least two months after the tipping alleged in the *Siegel* case, Carnation issued statements denying the existence of any corporate developments that would account for price surges in the company's stock. The Commission found that those statements were materially false and misleading. See *In re Carnation Co.*, Exchange Act Release No. 22,214, 33 S.E.C. Dkt. 1025 (July 8, 1985).

¹² Numerous cases in recent years have charged that persons traded illegally in target company stocks while in possession of non-public information regarding a tender offer to be made for the company. See, e.g., *United States v. Newman*, 664 F.2d 12,

(or knows it will receive) such an offer, a company cannot truthfully tell its shareholders that there are no significant corporate developments.

B. The Agreement In Principle Test Adopted By The Third And Seventh Circuits Is Inconsistent With The Objectives Of The Securities Laws

In contrast to the discerning inquiry that *Northway* requires and which many courts have undertaken (see note 6, *supra*), the Third and Seventh Circuits have adopted the rule that as a matter of law merger negotiations are not material until the parties reach an agreement in principle, defined as agreement on "price and structure." *E.g.*, *Staffin*, 672 F.2d at 1207; *Heublein*, 742 F.2d at 757;¹³ see *Flamm v. Eberstadt*, No. 86-1754, (7th Cir. Mar. 9, 1987), slip op. 16; *Jordan v. Duff & Phelps, Inc.*, No. 86-1611 (7th Cir. Mar. 17, 1987), slip op. 1.¹⁴ The agreement in principle rule is not based on the conclusion that no earlier merger activity is important to the reasonable investor. See *Flamm*, slip op. 9 (the notion that preliminary merger negotiations are not

aff'd after remand, 722 F.2d 729 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); *SEC v. Siegel*, No. 87 Civ. 0963 (S.D.N.Y. Feb. 13, 1987); *SEC v. Boesky*, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986); *SEC v. Levine*, No. 86 Civ. 3726 (S.D.N.Y. May 12, 1986).

¹³ The district court in this case applied a modified version of the *Staffin/Heublein* standard, holding that merger negotiations are not material, as a matter of law, until agreement in principle is "reasonably certain" (Pet. App. 65a).

¹⁴ In *Flamm* and *Jordan* the Seventh Circuit applied the agreement in principle test to what it treated as mere failures to disclose. The Seventh Circuit reserved the question whether it would apply the agreement in principle test in a case involving false or misleading corporate statements. *Flamm*, slip op. 18. Contrary to petitioners' suggestion, we do not believe that in *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (1983), the Second Circuit abandoned its traditional standard of materiality in favor of the agreement in principle test. See Gov't Amicus Br. in Support of Pet. 12 n.13.

important to investors "is simply another cause for wonderment at the legal mind"). Rather, it has been defended on the basis of three policy considerations unrelated to the *Northway* standard: first, that disclosure of early negotiations "may itself be misleading to shareholders," since investors may be lured into false optimism about merger prospects that fail to materialize (*Heublein*, 742 F.2d at 756; see also *Staffin*, 672 F.2d at 1206); second, that the agreement in principle test provides "a useable and definite measure for determining when disclosures need be made" (*Heublein*, 742 F.2d at 757; see also *Flamm*, slip op. 15); and third, that earlier disclosure "might seriously inhibit such acquisitive ventures" (*Heublein*, 742 F.2d at 757; see also *Flamm*, slip op. 10, 12-15; *Staffin*, 672 F.2d at 1206-1207).¹⁵

The first rationale—essentially that accurate disclosure of merger activity is impossible—has no plausible basis; it assumes that companies and investors lack the capacity, respectively, to communicate and comprehend. But the proposition that the English language is incapable of supplying words that disclose merger activity without overstatement or understatement is a frontal assault on the disclosure philosophy of the securities laws. As the Seventh Circuit recently observed (*Flamm*, slip op. 10-11), the proposition that shareholders will inevitably misunderstand:

¹⁵ The policy considerations articulated by the Third and Seventh Circuits do not apply in all fraud cases. In particular, they do not apply in an insider trading case, since a corporate insider need not make disclosure at all (indeed, it probably would be a breach of duty to do so), but can simply refrain from trading. See, *e.g.*, *Chiarella v. United States*, 445 U.S. at 227. Thus, a separate objection (beyond those discussed in the text) to skewing the definition of materiality on account of these policy considerations is that doing so would make the same facts material in some legal contexts but not others, a result for which there is no warrant. The alternative, applying the agreement in principle test in all cases, would allow insider trading on highly significant information about pending acquisitions.

assumes that investors are * * * unable to appreciate—even when told—that mergers are risky propositions up until the closing. * * * To attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations, implies that they should not be told about new plants, new products, new managers, or any of the other changes in the life of the corporation.

The second justification for the agreement in principle test, the purported need for a "bright line" rule to provide corporate certainty, touches on matters of more substance. Clear-cut guides to conduct are desirable, but they also have their drawbacks especially where, as in this field, the topography is too uneven to permit the drawing of bright-line rules that serve the statutory objectives. Some measure of uncertainty is inherent in the *Northway* test of materiality because decisions about whether corporate information is material depend on all the circumstances. Any rule that makes a single event (such as the reaching of an agreement in principle) the conclusive determinant of materiality in all cases will either excuse some falsehoods about significant matters or impose liability on account of misstatements of trivial information, a result against which *Northway* cautioned.¹⁶

The third rationale for the agreement in principle test is that disclosure may affect or stifle merger negotiations. This is an important concern, but it does not warrant the conclusion that information is not material prior to an

¹⁶ See Staff of House Comm. on Interstate and Foreign Commerce, 95th Cong., 1st Sess., *Report of the Advisory Comm. on Corporate Disclosure to the Securities and Exchange Commission* 327 (Comm. Print 1977):

Although the Committee believes that ideally it would be desirable to have absolute certainty in the application of the materiality concept, it is its view that such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula. The Committee's advice to the Commission is to avoid this quest for certainty and to continue consideration of materiality on a case-by-case basis as problems are identified.

agreement in principle. As we have explained, companies have no general affirmative duty under the federal securities laws to disclose even material merger negotiations. Even in the face of inquiries, a company generally may remain silent, or say "no comment."¹⁷ Furthermore, even if some facts regarding negotiations are disclosed, many details, including the identity of the other party to the talks and the precise terms discussed, may often remain secret.¹⁸ It is also very possible that fears that accurate disclosure will inhibit negotiations have been greatly exaggerated.¹⁹ But the fundamental point is that the anti-

¹⁷ It has been suggested that a "no comment" response is impractical. In *Flamm*, slip op. 16-17, the Seventh Circuit stated that since companies may ordinarily wish to deny false rumors of corporate developments, a "no comment" response will effectively confirm that there are developments. But this dilemma is not resolved by allowing a company to make false denials of corporate developments. If false denials were permitted, then truthful denials would lose meaning, because the market would know that the company could be lying. For the market to have confidence in corporate statements, a consistent policy of truthfulness about material matters is essential (see note 20, *infra*).

¹⁸ For example, the instructions to Commission Schedule 14D-9 expressly draw a distinction, for purposes of disclosure of merger negotiations in Item 7 of that Schedule, between disclosing the fact of negotiations and disclosing the parties to the negotiations and the terms being discussed. The latter need not be disclosed if it would harm the negotiations. The limitations on the scope of disclosure required under Schedule 14D-9 were adopted in response to industry concerns that too much disclosure would stifle negotiations. See Exchange Act Release No. 6,158, 18 S.E.C. Dkt. 1053, 1070 (Nov. 29, 1979). Although this degree of disclosure may often also be sufficient for purposes of the antifraud provisions of the securities laws, it should be noted that under some circumstances additional disclosure might be necessary under those provisions. *Ibid.*

¹⁹ One recent commentator notes that "[t]he notion that early disclosure prevents mergers has never been empirically confirmed. * * * Courts have relied solely on assertions of the business community and representatives of the stock market." Comment, *Disclosure of Preliminary Merger Negotiations Under Rule 10b-5*, 62 Wash. L. Rev. 81, 94 (1987) (footnote omitted).

fraud provisions of the federal securities laws, and the philosophy on which they are based, simply do not permit corporate managements to utter materially misleading statements in order to achieve the greater good for some (or even all) shareholders.²⁰ No rule of law condones fraud simply so that other corporate goals might thereby be served.²¹

C. This Case Should Be Remanded For An Assessment of Materiality Under the Correct Standard

While the decision below correctly rejected the agreement in principle test, it did not evidence the careful inquiry we have described. Instead, it suggested that "information concerning ongoing acquisition discussions becomes material *by virtue of the statement denying their existence*" (Pet. App. 13a (emphasis in original)), and

²⁰ Such misstatements also impair capital markets. As the Commission stated in *In re Carnation Corp.*, 33 S.E.C. Dkt. at 1030:

The importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be over-emphasized. To the extent that investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike.

²¹ The Seventh Circuit has suggested that a corporation may have a duty to its shareholders to remain silent as to the state of merger negotiations. See *Flamm*, slip op. 12-15. The court reasoned that while some shareholders may, as a result of corporate silence, sell their stock at less than they might have received if they had known of the prospective merger, the silence helps to assure that the shareholders overall will benefit from a successful merger. But where silence would be fraudulent, such as where the company is trading in its own securities, the company cannot remain silent. And, if the company chooses to speak, basic principles prohibit it from lying about material events and thereby misleading both shareholders and the trading market. Cf. 2 F. Harper, F. James & O. Gray, *The Law of Torts* § 7.2 at 388 (2d ed. 1986) (footnote omitted) (even at common law, "[a] plaintiff is within the scope of the duty not to deceive where defendant intended him to act on the misrepresentation whether or not defendant's motives were benign or altruistic.").

that "once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material, because they make the statement made untrue" (*id.* at 14a-15a (footnote omitted)). This apparent equating of falsehood and materiality has no basis under *Northway* and would appear to render any false statement, regardless of how trivial, per se material.²² Because the court of appeals confused the falsity of a statement with the materiality of negotiations, it failed to specify the factors to be considered in assessing materiality and failed to apply the correct standard to the facts of this case. Accordingly, the judgment below should be vacated and the case should be remanded for a determination of materiality on the basis of the principles set forth above.

We believe there is sufficient evidence for a trier of fact to find that at the time of the second and third statements, the events had created a significantly greater possibility of a value-affecting acquisition than investors had reason to expect on the basis of publicly available information. We therefore disagree with the district court's conclusion that those events were immaterial as a matter of law and with its grant of summary judgment as to Basic's second and third public statements. Reviewing the events in the months prior to the two statements (Pet. App. 100a), the district court concluded "that, considered most favorably for the plaintiffs, they represented preliminary merger discussions between Combustion and Basic." The possibility of a merger between Combustion and Basic was being seriously discussed at the highest levels of the two companies. Basic's chairman (and chief executive officer) was personally involved in discussions with a senior officer of Combustion, who in turn, the district court found, was keeping his superiors advised of the state of discussions (*id.* at 70a-71a). Far from

²² The court may not have intended such a result. One of the judges on the *Basic* panel, concurring in the denial of rehearing en banc, expressly took the position that the decision does not stand for this result (Pet. App. 145a-146a).

rebuffing Combustion's overtures, Basic at least entertained the prospect of a merger, the companies had begun to discuss price (*id.* at 77-78a, 101a), and Basic provided confidential financial information to Combustion to assist it in preparing an offer (*id.* at 71a-73a, 81a-85a, 101a).

Basic's first statement was issued approximately fourteen months before a merger agreement was reached and almost a year before the second statement. The courts below viewed the evidence of merger activity prior to the first statement differently. The district court indicated that, prior to that statement, Combustion on several occasions expressed interest in acquiring Basic (Pet. App. 50a, 53a-55a), but that there was no evidence that other conversations between the companies, alleged by plaintiffs to be merger discussions, related to an acquisition rather than to other business (*id.* at 48a, 55a-56a). In the district court's view, Basic had expressed no reciprocal interest in a merger at that point (*id.* at 55a) and was, in fact, not interested (*id.* at 45a), although it gave Combustion confidential financial information that could be found to have been given "in connection with" Combustion's expression of interest (*id.* at 52a).²³ This description of the events would support a conclusion that although, like many companies at most times, Basic was a subject of some acquisition interest, events had not yet significantly increased the possibility that the company would be acquired.

The court of appeals read the record on the motion for summary judgment differently. It said that in September 1976, a year before the first statement, Basic's chairman had been approached by Combustion's vice president to discuss the possibility of a merger (Pet. App. 3a-4a), and that the companies had "numerous" telephone con-

²³ The court also stated that Basic's internal discussions of Combustion's interest in acquiring Basic took place in the context of discussing several companies' interest in Basic (Pet. App. 45a-46a, 51a), and that Basic met with its investment bankers to discuss possible acquisitions by Basic of two companies, not Combustion's possible acquisition of Basic (*id.* at 56a).

versations and meetings to discuss a possible merger (*id.* at 4a). The court also stated that Basic gave Combustion confidential financial information, that Basic's lawyers discussed a possible Combustion bid, and that Basic and its investment bankers discussed preparation of an evaluation of Basic to use in merger negotiations (*id.* at 4a-5a). On remand, the court of appeals will have to determine whether summary judgment as to the first statement was warranted under the proper standard of materiality.

II. RESPONDENTS WERE ENTITLED TO A REBUTTABLE PRESUMPTION OF RELIANCE UNDER THE FRAUD ON THE MARKET THEORY

The court of appeals in this case correctly held, as has every other court to consider the issue,²⁴ that a plaintiff alleging fraud under Rule 10b-5 may, in circumstances where a materially false or misleading corporate statement has been disseminated into the trading market, invoke a rebuttable presumption of reliance upon the integrity of the market price.

Reliance is generally part of the logical chain needed to establish that a defendant's misrepresentation or omission was the cause in fact of the plaintiff's injury. See

²⁴ See *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986); *Harris v. Union Electric Co.*, 787 F.2d 355, 367 & n.9 (8th Cir. 1986), cert. denied, No. 85-2036 (Oct. 6, 1986); *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), cert. denied, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), cert. denied, 459 U.S. 1102 (1983); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), vacated as moot after cert. granted, 459 U.S. 1027 (1982); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). See also *Flamm v. Eberstadt*, *supra*; *Wachovia Bank & Trust Co. v. National Student Marketing Corp.*, 650 F.2d 342, 358 (D.C. Cir. 1980), cert. denied, 452 U.S. 954 (1981); *In re LTV Securities Litigation*, 88 F.R.D. 134, 142 (N.D. Tex. 1980); *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982).

List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965). Although the requirement is ordinarily met by showing the plaintiff's actual subjective reliance on the defendant's statement (see 3 L. Loss, *Securities Regulation* 1430-1432 (2d ed. 1961)), courts have held that proof of such direct reliance is not necessary in certain cases, including those alleging a "fraud on the market."

The fraud on the market theory rests on two propositions (see Pet. App. 17a): that in an active secondary market the price of a company's stock is determined by all material information available regarding the company and its business;²⁵ and that investors rely on the integrity of market prices when making investment decisions. See, e.g., *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986); *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). These propositions together establish that such investors rely, albeit indirectly, on material misrepresentations concerning actively traded securities (Pet. App. 17a). See *Blackie v. Barrack*, 524 F.2d at 907.²⁶

Courts could have placed on the plaintiff the burden of demonstrating in a particular case that the market price

²⁵ Thus, the price of a stock may reflect, and be distorted by, any material misrepresentation about the company. See, e.g., *Peil v. Speiser*, 806 F.2d at 1160-1161; *Blackie v. Barrack*, 524 F.2d at 906; *In re LTV Securities Litigation*, 88 F.R.D. at 143-144; Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143, 1154-1156 (1982). See also *Flamm*, slip op. 19; *Seaboard World Airlines, Inc. v. Tiger International, Inc.*, 600 F.2d 355, 361-362 (2d Cir. 1979).

²⁶ To rebut the presumption, a defendant must show either that the market price did not reflect the corporate statements, or that the plaintiff did not rely on market price in trading (Pet. App. 18a n.6). See *Blackie v. Barrack*, 524 F.2d at 906; *Peil v. Speiser*, 806 F.2d at 1161. Some courts have extended the fraud on the market theory to initial public offerings. See, e.g., *T.J. Roney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d at 1330; *Shores v. Sklar*, 647 F.2d at 462; *Arthur Young & Co. v. United States District Court*, 549 F.2d 686 (9th Cir.), cert. denied, 434 U.S. 829 (1977). That issue is not present in this case and we do not address it.

reflected corporate misstatements and that he in fact relied on the integrity of the market price. In practice, however, every court that has adopted the fraud on the market theory in the context of an active secondary market has also applied a presumption in favor of the plaintiff as to these matters. Three well-founded reasons support this approach. First, the empirical and common-sense evidence in support of the two propositions comprising the theory is so strong that it is sensible, as a matter of logic and judicial efficiency, to apply a rebuttable presumption that the propositions are true. Second, the presumption facilitates important policy objectives underlying the federal securities laws.²⁷ Finally, the presumption relieves the plaintiff of an evidentiary burden it is not practical to place on him.

Studies have firmly established that active secondary markets are efficient transmitters of corporate information and that prices in such markets reflect that information.²⁸ In *In re LTV Securities Litigation*, 88 F.R.D. 134, 135, 144 (N.D. Tex. 1980), the court summarized the point, saying that numerous economic studies demonstrate that "the market price of [widely-followed securities of larger corporations] reflects all available public information—and hence, necessarily, any material misrepresentations as well." Many other courts have accepted the overwhelming empirical evidence that

²⁷ Presumptions are often applied to aid favored contentions or handicap disfavored ones. For example, "[a] classic instance [of a policy-based presumption] is the presumption of ownership-from possession, which tends to favor the prior possessor and to make for the stability of estates." C. McCormick, *Evidence* § 343, at 968 (3d ed. 1984) (footnote omitted).

²⁸ See, e.g., E. Fama, *Foundations of Finance* 320-382 (1976); J. Lorie & M. Harriston, *The Stock Market* 70-97 (1973); Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 551 (1984); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 Stan. L. Rev. 1031, 1034-1057 (1977).

the prices of securities traded in active secondary markets reflect information disseminated into those markets.²⁹

Courts have similarly accepted the common-sense observation that most investors rely on the integrity of the market in making trading decisions.³⁰ As one court has noted, "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982). The fact that investors are in the market at all is evidence that they rely on the assumption "that the market is not being manipulated as a result of anybody's false statement or misleading omission." *Ibid.*

The presumptions underlying the fraud on the market theory also promote important policies under the federal securities laws. The federal securities laws were adopted in large measure to restore integrity to, and investor con-

²⁹ See, e.g., *Flamm*, slip op. 19; *Peil v. Speiser*, 806 F.2d at 1163; *Harris v. Union Electric Co.*, 787 F.2d at 367 & n.9; *Seaboard World Airlines, Inc. v. Tiger International, Inc.*, 600 F.2d at 361-362; *Blackie v. Barrack*, 524 F.2d at 907; *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. at 538.

³⁰ Petitioners contend (Pet. 26-27) that even if a presumption of reliance is appropriate in a fraud on the market case brought by purchasers, it is inappropriate in a case brought by sellers. They argue that, even assuming persons might make decisions to purchase securities in the open market on the "relatively common basis" of market price, there is no reason to make the same assumption regarding decisions to sell, which might be made for other reasons, the most obvious being a need for cash. But petitioners point to no authority for the proposition that sellers are oblivious to price. In fact, at least one case did involve sellers. *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. at 535. See, generally Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. at 1153-1156. While sellers may have various reasons for selling, the vast majority rely on price to decide when and what security to sell. An investor needing cash, for example, would presumably evaluate the stock's market price in relation to other options, including borrowing money using the stock as collateral.

fidence in, the securities markets. The House Report recommending enactment of the Securities Exchange Act notes that honest corporate information is essential to assure that the markets reflect the "real value" of securities (H.R. Rep. 1383, 73d Cong., 2d Sess. 11 (1934) (emphasis added)):

No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that *competing judgments of buyers and sellers as to the fair price of a security brings [sic] about a situation where the market price reflects as nearly as possible a just price*. Just as artificial manipulation tends to upset the true function of an open market, so *the hiding and secreting of important information obstructs the operation of the markets as indices of real value*.

A fundamental premise of the Securities Exchange Act is, in short, that the markets are affected by information, so that "[t]here cannot be honest markets without honest publicity" (*ibid.*). An equally fundamental premise is that investors rely on the integrity of markets. A defendant contending that these basic premises are not true in a particular case should bear the burden of proving it.

The courts have viewed the fraud on the market theory, and the accompanying presumption of reliance, as a means of furthering the statutory goal of ensuring honest securities markets. See, e.g., *Lipton v. Documentation, Inc.*, 734 F.2d 740, 748 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985) ("The theory thus actually facilitates Congress' intent . . . by enabling a purchaser to rely on an expectation that the securities markets are free from fraud."); *In re LTV Securities Litigation*, 88 F.R.D. at 145. To the extent that private securities fraud actions may be prosecuted more efficiently by adoption of the fraud on the market theory and its presumption of

reliance, the enforcement of the securities laws, and the underlying goal of honest markets, are furthered.³¹

Finally, placing the burden of proof on a plaintiff alleging fraud on the market would impose an unrealistic evidentiary burden. See *Lipton v. Documation, Inc.*, 734 F.2d at 743; *Panzirer v. Wolf*, 663 F.2d at 367; *Blackie v. Barrack*, 524 F.2d at 907; *Rosenberg v. Digilog, Inc.*, 648 F. Supp. 40, 43 (E.D. Pa. 1985).³² Of course, a plaintiff could offer evidence that he relied on the integrity of the market in making his investment decision. But proving affirmatively that the market price of a security was affected by corporate misstatements may be difficult. A plaintiff might have to present extensive and hard to obtain evidence as to who in fact traded in the stock following the corporate statement, how many of those traders were in fact aware of the statement and whether they in fact relied on the statement in making their trad-

³¹ This Court has "repeatedly * * * emphasized * * * that implied private actions [under Rule 10b-5] provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

³² Petitioners argue (Pet. 22) that the presumption has been applied improperly to facilitate class certification. The district court in this case, however, expressly disclaimed any intention of seeking to facilitate class actions (Pet. App. 129a). The court of appeals, although recognizing that the presumption does facilitate class actions, did not use that circumstance to justify its decision. Contrary to petitioners' assertion, the presumption of reliance in a fraud on the market case is grounded on characteristics of the securities markets and investor behavior, as well as on policy objectives, that are equally applicable to individual and class actions. See Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 Geo. Wash. L. Rev. 627, 645-653 (1982); Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. at 1154-1156.

ing decisions. Cf. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970) (misleading proxy statements).³³

The fraud on the market theory merely accommodates these various concerns by recognizing the obvious, that market prices generally reflect corporate information and that investors generally rely on the integrity of the market price, and by relieving plaintiffs of the need to reprove these matters in each case.³⁴ The theory does not dispense with the requirement of reliance in Rule 10b-5 cases but places the burden on the defendant to prove that a particular case is atypical. In so doing, the fraud on the market theory facilitates securities fraud actions by injured investors, allows those actions to be prosecuted with greater judicial efficiency, and promotes important goals of investor protection under the federal securities laws.

³³ In *Mills*, this Court adopted a presumption that a misleading proxy statement caused injury alleged to have resulted from a shareholders' vote in favor of a merger. The Court rejected the argument that a plaintiff should be required to prove that the proxy statement had a decisive effect on the vote. So long as the misstatements were material, and the proxy solicitation was an "essential link" in effecting the merger, this Court held, "a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress * * *" (396 U.S. at 385). Such a result, the Court said, "will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice * * *" (*ibid.*).

³⁴ While the fraud on the market theory permits a presumption that material misstatements affected the market price, the plaintiff retains the burden of establishing, in a manner that will vary from case to case, the amount of his damages.

CONCLUSION

The judgment of the court of appeals should be affirmed in part and vacated in part, and the case should be remanded for further proceedings.

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AMICUS CURIAE

BRIEF

In the Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ET AL., PETITIONERS

v.

MAX L. LEVINSON, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

**BRIEF FOR THE
SECURITIES AND EXCHANGE COMMISSION
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QUESTIONS PRESENTED

1. Whether the court of appeals employed the correct standard for determining that a corporation's merger negotiations were material to investors, for purposes of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

2. Whether a plaintiff who traded in a corporation's stock on a securities exchange after the issuance of a materially false statement by the corporation is entitled to a rebuttable presumption that he relied on the market price in so trading.

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In the Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-279

BASIC INCORPORATED, ET AL., PETITIONERS

v.

MAX L. LEVINSON, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUITBRIEF FOR THE
SECURITIES AND EXCHANGE COMMISSION
AS AMICUS CURIAEINTEREST OF THE
SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission is the agency responsible for the administration and enforcement of the federal securities laws. This case presents two important questions arising under the antifraud provisions of those laws. The first is the proper standard for assessing the materiality of corporate merger negotiations and other pre-merger activity. In this case, the issue arises in the context of a private damage action against a corporation that was a party to a proposed merger. The same question also arises in other fraud cases, such as private damage actions alleging unlawful insider trading by persons in possession of material, non-public information about merger activity, and in enforcement actions brought by the SEC.

The second question is whether a plaintiff who alleges that a corporate misstatement constituted a "fraud on the market" in which he traded is entitled to a rebuttable

presumption of reliance. Under the fraud on the market theory, which has been adopted by every court (including eight courts of appeals) to address it, it is presumed that any material corporate misstatement was reflected in the market price of the security and that investors, in making decisions to trade, relied on the integrity of the market price and thus indirectly relied on the misstatement. While the issue does not arise in Commission actions, in which reliance need not be shown, it is often important in private actions to enforce the securities laws, which are a "necessary supplement" to the Commission's enforcement actions. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

STATEMENT

1. Respondents, former shareholders of Basic Incorporated (Basic), brought this class action against petitioners—the corporation and certain of its officers and directors—alleging that petitioners issued three false or misleading public statements in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. Respondents claim that they sold shares of Basic stock in a market artificially affected by these statements (Pet. App. 2a).

Following unusual trading activity in the company's stock, Basic released a public statement on October 21, 1977, reciting that "the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger" (Pet. App. 5a). Respondents claim that when Basic issued that public statement the company was in fact engaged in merger negotiations with Combustion Engineering, Inc. (Combustion), which eventually acquired Basic (see *id.* at 4a-5a). The second and third allegedly false public statements were made on September 25, 1978, and November 6, 1978. On both occasions, Basic announced that its management was "unaware of any present or pending corporate development[s]" that would account for a recent upsurge in

trading activity in Basic stock. Respondents contend that these statements were false or misleading because Basic in fact continued to engage in merger negotiations with Combustion (see *id.* at 5a-7a). On December 20, 1978, Basic announced its approval of a tender offer by Combustion to acquire all of Basic's outstanding shares at a price of \$46 per share (*id.* at 22a).

The respondent class consists of persons who sold shares of Basic stock on the New York Stock Exchange on various dates between October 21, 1977 and December 15, 1978, allegedly as a result of one or more of the three statements, at prices allegedly affected by the statements and substantially below \$46. The district court certified the class after determining that common issues predominated over individual issues (Pet. App. 119a, 127a). An important factor in this determination was the court's conclusion that under the "fraud on the market theory" reliance by each class member on the company's statements could be presumed and that there was no need for each class member to prove subjective reliance (*id.* at 118a).

The district court granted summary judgment for the defendants. It found (see Pet. App. 9a) that Basic's first statement on October 21, 1977 was not false or misleading because there were no negotiations occurring at that time, and that the second (September 25, 1978) and third (November 6, 1978) statements, although made while negotiations were occurring, were not materially false or misleading because the negotiations were not "destined with reasonable certainty, to become a merger agreement in principle" (*id.* at 103a). In so ruling, the court relied on a modified version of the test for the materiality of merger negotiations announced by the Third Circuit in *Staffin v. Greenberg*, 672 F.2d 1196 (1982). Under that test, as subsequently reaffirmed and refined by the Third Circuit in *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (1984), cert. denied, 469 U.S. 1215 (1985), merger negotiations are not material until the parties reach an agreement in principle (defined as agreement on price and structure).

2. The Sixth Circuit reversed, concluding that all three of the challenged statements were false or misleading and expressly disagreeing with the Third Circuit's test for materiality. The court of appeals held that, at least where false or misleading corporate statements (rather than a mere failure to disclose) are involved, merger negotiations need not reach an agreement in principle before they become material (Pet. App. 13a-15a). With respect to the negotiations here, the court stated that it was "inconceivable" that Basic stockholders would not find the fact that discussions were occurring between Combustion and Basic, in light of Basic's statements, to be important and, therefore, material to making normal reasonable investment decisions" (*id.* at 13a). The court of appeals added that where, as here, a company chooses to make public statements denying corporate developments, events "that might not have been material in absence of the denial are material because they make the statement made untrue" (*id.* at 13a-15a).

As to class certification, the Sixth Circuit agreed with the district court that under the fraud on the market theory respondents were entitled to a presumption of reliance, that common class issues therefore predominated over individual issues, and that class certification was appropriate (Pet. App. 19a).

SUMMARY OF ARGUMENT

1. Except in certain limited circumstances, a company has no affirmative duty to disclose ongoing merger negotiations. If, however, a company chooses to speak publicly, it must not misstate a "material" fact or omit a "material" fact if the omission makes the statement misleading. A fact is "material" if there is a "substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision about the company's stock. *TSC Industries, Inc. v. Northway, Inc.*,

426 U.S. 438, 449 (1976). Where the fact is the possibility of a future, uncertain event, such as a possible merger, its materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in the light of the totality of the company[']s activity" (*SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)). Under this standard, discussions and other activities looking toward a possible merger (merger activity) may be material to investors before there is an agreement in principle to merge. Tentative overtures or inquiries will often be immaterial. But if negotiations or other corporate activity not yet disclosed has significantly increased the possibility of a merger that can be expected to affect the value of an investment in the company's securities, that significantly increased possibility will normally be material information.

The courts that have held that merger activity is not material until an "agreement in principle" is reached have done so not because they view all prior merger activity as unimportant to a reasonable investor but because of three concerns about the consequences of earlier disclosure. One concern, that disclosure prior to an agreement in principle will inevitably be misleading, is unfounded: corporate officials and their advisers should be capable of accurately describing the situation without understating or overstating the likelihood that a merger will occur. A second concern, that corporations need a "bright line" test of when merger activity becomes material, also does not warrant use of the agreement in principle standard. Inherent in the *Northway* "reasonable person" standard of materiality is the understanding that many decisions as to materiality will require the exercise of judgment by persons responsible for corporate disclosure; any bright line rule would inevitably be overinclusive or underinclusive. The third concern, that accurate disclosure may affect or scuttle some negotiations, is an im-

portant one, but it does not warrant the conclusion that information is not material prior to an agreement in principle. In most circumstances, the company has the option of remaining silent or declining to comment. Where disclosure is required, many of the details may often be kept secret. In any event, concerns about affecting the course of negotiations do not justify allowing corporations to make materially false or misleading statements on which investors may rely.

2. The courts below properly applied a presumption of reliance by a plaintiff who alleges that corporate misstatements constituted a "fraud on the market." The fraud on the market theory, which has been adopted by all eight courts of appeals that have considered the matter, consists of two rebuttable presumptions: that all information, including corporate misstatements, disseminated into an active secondary market is reflected in the price of securities traded in that market; and that investors who buy and sell after a misstatement has been made rely on the integrity of the market price and are therefore relying indirectly on the misstatement. Under this theory, direct reliance on a corporate misstatement need not be proved.

The fraud on the market theory is amply supported by extensive empirical evidence about the functioning of capital markets and by common-sense observations about investor behavior. The presumption of reliance promotes judicial efficiency; it is consistent with basic assumptions regarding the operation of capital markets that underlie the federal securities laws; it promotes the integrity of those markets by facilitating the prosecution of private securities fraud actions; and it eliminates the need for investors to meet often impractical evidentiary burdens.

ARGUMENT

I. THE MATERIALITY OF ONGOING MERGER ACTIVITY MUST BE JUDGED ON THE FACTS OF EACH CASE, TAKING INTO ACCOUNT THE SIGNIFICANCE THE MERGER WOULD HAVE FOR THE COMPANY AND THE LIKELIHOOD OF ITS OCCURRENCE

A. Ongoing Merger Discussions May Be Material Before An Agreement To Merge Is Reached

1. As the court below recognized, a company generally has no affirmative duty under the federal securities laws to disclose ongoing merger activity and may elect to remain silent even if the information would be material to investors (see *Pet. App. 9a*). Disclosure is required only in certain limited circumstances, such as where a company is trading in its own stock, and thus has a duty to disclose all material information,¹ where the company is responsible for leaks into the market² or where regulations promulgated by the Commission require disclosure.³

¹ See, e.g., *Jordan v. Duff & Phelps, Inc.*, No. 86-1611 (7th Cir. Mar. 17, 1987), slip op. 10; *Staffin v. Greenberg*, 672 F.2d 1196, 1205 (3d Cir. 1982); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), cert. denied, 419 U.S. 830 (1974). See generally *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

² See, e.g., *State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981).

³ For example, a company is required to disclose on Schedule 14D-9 merger negotiations undertaken in response to a tender offer. 17 C.F.R. 240.14d-101, Item 7. See *In re Revlon, Inc.*, Exchange Act Release No. 23,320, 25 S.E.C. Dkt. 1541, 1550-1552 (June 16, 1986). See also Item 3(b) of Schedule 14D-1, 17 C.F.R. 240.14d-100; Item 3(b) of Schedule 13E-3, 17 C.F.R. 240.13e-100; Item 504 of Regulation S-K, Instruction 6, 17 C.F.R. 229.504. The fact that a Commission form or schedule requires disclosure does not necessarily mean that the information would be material in the absence of that disclosure requirement.

But it is a different situation when a company chooses to make "assertions . . . in a manner reasonably calculated to influence the investing public." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). Then the company violates Rule 10b-5 when the information it disseminates contains a material misstatement or omits to state a material fact whose omission renders the statement misleading. *Ibid.*

2. In general, a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if it would have "significantly altered the 'total mix' of information made available" to the shareholder. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (footnote omitted).⁴ Where a corporate development is certain, its significance to investors depends on its importance to the company's fortunes. But where a potential future event is not certain to occur, as is the case with a possible merger, the assessment of materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company[']s activity." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 849. Accord, *SEC v. MacDonald*, 699 F.2d 47, 50 (1st Cir. 1983); *SEC v. Mize*, 615 F.2d 1046, 1051 (5th Cir.), cert. denied, 449 U.S. 901 (1980); *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 887-888 (2d Cir. 1972). Ordinarily, neither the probability nor the magnitude of a prospective event can be

⁴ *Northway* arose under the proxy solicitation provisions of the Securities Exchange Act, but subsequent decisions have applied its test of materiality in cases arising under Section 10(b) and Rule 10b-5, involving purchases and sales of securities. See, e.g., *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 466 n.4 (7th Cir.), cert. denied, 454 U.S. 835 (1981); *Goldberg v. Meridor*, 567 F.2d 209, 218 (2d Cir. 1977), cert. denied, 434 U.S. 1009 (1978); *Healey v. Catalyst Recovery of Pennsylvania, Inc.*, 616 F.2d 641, 647 (3d Cir. 1980).

stated with mathematical precision. See *Northway*, 426 U.S. at 448. But imprecision is inherent in the *Northway* standard of materiality, of which the probability/magnitude formula is a part. See *id.* at 450 ("[t]he determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him.").

3. In accordance with these principles, the materiality of merger discussions must be judged in each case on its facts. For example, in *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974), the court, in considering the materiality of merger discussions, refused to "establish a rule as to when information . . . becomes material" because such a determination must be made "'according to the fact pattern of each specific transaction.'" *Id.* at 1306 (quoting *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d at 888). Accord, *Grigsby v. CMI Corp.*, 765 F.2d 1369, 1373, 9th Cir. 1985) ("The materiality of preliminary merger negotiations depends on the facts of the case.").

A merger is often such a significant event that, even where agreement is far from certain, the existence of merger activity may be material to investors.⁵ In *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976)—a case in which "embryonic" merger talks were held to be material—Judge Friendly stated that since "a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death," negotiations "can become material at an earlier stage than would be the case as regards lesser trans-

⁵ See, e.g., Dennis & McConnell, *Corporate Mergers and Security Returns*, 16 J. Fin. Econ. 143, 154 (1986) (average increase of 8.56% in price of acquired companies' shares in two-day period surrounding announcement of a merger); Jensen & Ruback, *The Market for Corporate Control*, 11 J. Fin. Econ. 5, 7-8 (1983) (average gain to target company shareholders of 20%); *Economic Report of the President* 197 (1985) ("recent studies find average gains [from successful takeovers] in the range of 16 to 34 percent of the value of the target's shares").

actions—and this even though the mortality rate of mergers in such formative states is doubtless high.”⁶

The possibility of a merger may have an immediate importance to investors in the company's securities even if no merger ultimately takes place. For example, in *SEC v. Gaspar*, [1984-1985] Fed. Sec. L. Rep. (CCH) ¶ 92,004 (S.D.N.Y. 1985), the company's announcement of preliminary (though ultimately unsuccessful) merger talks sent the stock's price soaring by more than 40% on greatly increased volume.⁷ And, as recent events illus-

⁶ See also *SEC v. Shapiro*, 494 F.2d 1301, 1306-1307 (2d Cir. 1974); *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 368 (2d Cir.), cert. denied, 414 U.S. 910 (1973); *Holmes v. Bateson*, 583 F.2d 542, 558 (1st Cir. 1978) (merger negotiations that had not yet reached the point of discussing terms were nonetheless material); *Rogen v. Ilikon Corp.*, 361 F.2d 260, 266 (1st Cir. 1966) (“[e]ven with the possibility of [their] collapse,” negotiations could be material); *Dungan v. Colt Industries, Inc.*, 532 F. Supp. 832, 837 (N.D. Ill. 1982) (fact that the defendants were seriously exploring the sale of their company was material); *American General Insurance Co. v. Equitable General Corp.*, 493 F. Supp. 721, 744-745 (E.D. Va. 1980) (merger negotiations were material four months before agreement in principle was reached); *Levin v. Marder*, 343 F. Supp. 1050, 1058 (W.D. Pa. 1972) (“‘preliminary proposal’” of merger “may well be material”); *Schlanger v. Four-Phase Systems, Inc.*, 582 F. Supp. 128, 131-132 (S.D.N.Y. 1984) (“no corporate developments” statement issued by a company in the face of unusually heavy market activity in its stock could be materially false or misleading in that it failed to disclose pending merger negotiations that had not reached the point of agreement); *In re Carnation Corp.*, Exchange Act Release No. 22,214, 33 S.E.C. Dkt. 1025, 1031-1034 (July 8, 1985) (materially misleading to issue two “no corporate developments” statements in response to unusual market activity at a time when the company was engaged in preliminary merger discussions that were far from certain to result in an agreement).

⁷ See also Mikkelsen & Ruback, *An Empirical Analysis of the Interfirm Equity Investment Process*, 14 J. Fin. Econ. 523, 535 (1985) (finding an average 7.74% increase in stock price following Commission filings by persons who acquire 5% or more of a company's stock and indicate that they are considering acquiring control, but only 3.24% increase where investment intent only was expressed). Other studies show a consistent price rise in the poten-

trate, enormous illegal profits may be obtained by insiders privy to early merger discussions and by their tippees who trade in the target's stock before an agreement in principle has been reached.⁸

Not every conversation or other activity that might eventually lead to a merger is material. As this Court stated in *Northway*, “[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good” (426 U.S. at 448). The possibility of acquisition exists, in varying degrees, for many companies much of the time, and overtures unlikely

tial target's securities over a substantial period leading up to the day of the public announcement of a merger or merger negotiations; this is presumably due either to illegal trading by those with access to information about the merger activity, or legal trading by persons trading on educated speculation or rumors about a possible merger, or both. See Office of the Chief Economist, SEC, *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?* 17-20, 27-29, Table 7 (Feb. 24, 1987); Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. Fin. 855 (1981).

⁸ See, e.g., *SEC v. Boesky*, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986), discussed in Lit. Release No. 11,288, 37 S.E.C. Dkt. 78 (Dec. 2, 1986); *SEC v. Levine*, No. 86 Civ. 3726 (S.D.N.Y. May 12, 1986), discussed in Lit. Release No. 11,095, 35 S.E.C. Dkt. 1212 May 27, 1986; *SEC v. Katz*, No. 86 Civ. 6,088 (S.D.N.Y., filed Aug. 7, 1986), discussed in Lit. Release No. 11,185, 36 S.E.C. Dkt. 448 (Aug. 19, 1986); *SEC v. Thayer*, No. CA-3-84-0471-R (N.D. Tex. May 7, 1985), discussed in Lit. Release No. 10,746, 33 S.E.C. Dkt. 74 (May 21, 1985); *SEC v. Gaspar*, [1984-1985] Fed. Sec. L. Rep. (CCH) ¶ 92,004; *SEC v. Siegel*, No. 87 Civ. 0963 (S.D.N.Y., filed Feb. 13, 1987), discussed in Lit. Release No. 11,354, 37 S.E.C. Dkt. 1276 (Mar. 3, 1987). One commentator has noted (Olson, *Revealing Merger Talks: When, How Are Critical, Legal Times*, Oct. 14, 1985, at 22 (emphasis in original)):

As market activity based on acquisition rumors in case after case has shown, preliminary merger or takeover discussions are significant to investors in the target's securities and no amount of well-intentioned judicial rationalization in the search for bright-line rules can make that simple fact of materiality disappear.

to lead anywhere are common.⁹ But if events not yet disclosed have significantly increased the possibility of an acquisition at a premium price (or on any terms that are likely to affect the value of an investment in the company's securities), that significantly increased possibility is material information even if no agreement on price and structure has been reached: it is obvious that a reasonable investor would attach importance to such a development.¹⁰ The willingness of securities professionals to spend enormous sums to trade while in possession of information about early merger activity is ample evidence of the information's significance.¹¹

⁹ See, e.g., *Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075, 1085 (5th Cir. 1970), in which the court held immaterial a "unilateral offer to negotiate" made by a large shareholder of the potential acquiror that was repudiated two days later by the potential target's board, was never acknowledged by the potential target and "never got off the ground". See also *List v. Fashion Park, Inc.*, 340 F.2d 457, 464 (2d Cir.), cert. denied, 382 U.S. 811 (1965) (president of company knew nothing more than the name of a potential purchaser); *Bucher v. Shumway*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,142, at 96,302 (S.D.N.Y. Oct. 11, 1979) ("mere overtures or inquiries"), aff'd without opinion, 622 F.2d 572 (2d Cir.), cert. denied, 449 U.S. 841 (1980); *Berman v. Gerber Products Co.*, 454 F. Supp. 1310, 1316, 1318 (W.D. Mich. 1978) ("mere overtures"); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 65 (D.N.J. 1974) ("casual inquiry").

¹⁰ The stage at which merger activity becomes material depends in part on the likelihood of a premium price or other effect on value. For example, the effect of acquisitions on the prices of securities of acquiring companies, which generally are larger than acquired companies, is less certain. See, e.g., Jensen & Ruback, *The Market for Corporate Control*, 11 J. Fin. Econ. 5, 16-17 (1983); Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. Fin. Econ. 105, 134-135 (1980). Thus, merger activity might become material to investors trading in the potential acquiror's stock at a later stage than to investors in the potential target.

¹¹ For example, in one case recently brought by the Commission, an investment banker retained by the Carnation Company was alleged to have tipped an arbitrageur about a possible friendly

When a target company and an acquiror have both exhibited serious interest in an acquisition, there is ordinarily a significantly increased possibility that it will occur. The degree of interest of the target company and the potential acquiror is of course evidenced not only by their overt expressions but also by their conduct, including the time and resources devoted to the possible acquisition, the level in each company at which it is considered, the extent to which experts, such as outside counsel or investment bankers, are involved, and similar factors. An agreement on price and structure is surely a sufficient, but not a necessary, indicator of enough mutual interest to show that the possibility of a consummated transaction has been significantly increased.

There will also be instances where merger activity is material before the target has expressed any interest. In appropriate circumstances, the mere fact that an offer is to be made can be material. Some offers may be so attractive that they are very unlikely to be refused. In addition, friendly offers are commonly a prelude to hostile tender offers (see 1 M. Lipton & E. Steinberger, *Takeovers & Freezeouts* § 6.04[1], at 6-47 (1986)), the materiality of which is beyond doubt.¹² If it has received

takeover of Carnation by Nestle Corporation. The tipping occurred over a period three to five months before an agreement in principle was reached. The arbitrageur purchased 1.7 million shares of Carnation common stock and realized a profit of approximately \$28.3 million after the merger was announced. See *SEC v. Siegel*, No. 87 Civ. 0963 (S.D.N.Y., filed Feb. 13, 1987), discussed in Lit. Release No. 11,354 37 S.E.C. Dkt. 1276 (Mar. 3, 1987). At least two months after the tipping alleged in the *Siegel* case, Carnation issued statements denying the existence of any corporate developments that would account for price surges in the company's stock. The Commission found that those statements were materially false and misleading. See *In re Carnation Co.*, Exchange Act Release No. 22,214, 33 S.E.C. Dkt. 1025 (July 8, 1985).

¹² Numerous cases in recent years have charged that persons traded illegally in target company stocks while in possession of non-public information regarding a tender offer to be made for the company. See, e.g., *United States v. Newman*, 664 F.2d 12,

(or knows it will receive) such an offer, a company cannot truthfully tell its shareholders that there are no significant corporate developments.

B. The Agreement In Principle Test Adopted By The Third And Seventh Circuits Is Inconsistent With The Objectives Of The Securities Laws

In contrast to the discerning inquiry that *Northway* requires and which many courts have undertaken (see note 6, *supra*), the Third and Seventh Circuits have adopted the rule that as a matter of law merger negotiations are not material until the parties reach an agreement in principle, defined as agreement on "price and structure." *E.g.*, *Staffin*, 672 F.2d at 1207; *Heublein*, 742 F.2d at 757;¹³ see *Flamm v. Eberstadt*, No. 86-1754, (7th Cir. Mar. 9, 1987), slip op. 16; *Jordan v. Duff & Phelps, Inc.*, No. 86-1611 (7th Cir. Mar. 17, 1987), slip op. 1.¹⁴ The agreement in principle rule is not based on the conclusion that no earlier merger activity is important to the reasonable investor. See *Flamm*, slip op. 9 (the notion that preliminary merger negotiations are not

aff'd after remand, 722 F.2d 729 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983); *SEC v. Matera*, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); *SEC v. Siegel*, No. 87 Civ. 0963 (S.D.N.Y. Feb. 13, 1987); *SEC v. Boesky*, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986); *SEC v. Levine*, No. 86 Civ. 3726 (S.D.N.Y. May 12, 1986).

¹³ The district court in this case applied a modified version of the *Staffin/Heublein* standard, holding that merger negotiations are not material, as a matter of law, until agreement in principle is "reasonably certain" (Pet. App. 65a).

¹⁴ In *Flamm* and *Jordan* the Seventh Circuit applied the agreement in principle test to what it treated as mere failures to disclose. The Seventh Circuit reserved the question whether it would apply the agreement in principle test in a case involving false or misleading corporate statements. *Flamm*, slip op. 18. Contrary to petitioners' suggestion, we do not believe that in *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (1983), the Second Circuit abandoned its traditional standard of materiality in favor of the agreement in principle test. See Gov't Amicus Br. in Support of Pet. 12 n.13.

important to investors "is simply another cause for wonderment at the legal mind"). Rather, it has been defended on the basis of three policy considerations unrelated to the *Northway* standard: first, that disclosure of early negotiations "may itself be misleading to shareholders," since investors may be lured into false optimism about merger prospects that fail to materialize (*Heublein*, 742 F.2d at 756; see also *Staffin*, 672 F.2d at 1206); second, that the agreement in principle test provides "a useable and definite measure for determining when disclosures need be made" (*Heublein*, 742 F.2d at 757; see also *Flamm*, slip op. 15); and third, that earlier disclosure "might seriously inhibit such acquisitive ventures" (*Heublein*, 742 F.2d at 757; see also *Flamm*, slip op. 10, 12-15; *Staffin*, 672 F.2d at 1206-1207).¹⁵

The first rationale—essentially that accurate disclosure of merger activity is impossible—has no plausible basis; it assumes that companies and investors lack the capacity, respectively, to communicate and comprehend. But the proposition that the English language is incapable of supplying words that disclose merger activity without overstatement or understatement is a frontal assault on the disclosure philosophy of the securities laws. As the Seventh Circuit recently observed (*Flamm*, slip op. 10-11), the proposition that shareholders will inevitably misunderstand:

¹⁵ The policy considerations articulated by the Third and Seventh Circuits do not apply in all fraud cases. In particular, they do not apply in an insider trading case, since a corporate insider need not make disclosure at all (indeed, it probably would be a breach of duty to do so), but can simply refrain from trading. See, *e.g.*, *Chisarella v. United States*, 445 U.S. at 227. Thus, a separate objection (beyond those discussed in the text) to skewing the definition of materiality on account of these policy considerations is that doing so would make the same facts material in some legal contexts but not others, a result for which there is no warrant. The alternative, applying the agreement in principle test in all cases, would allow insider trading on highly significant information about pending acquisitions.

assumes that investors are * * * unable to appreciate—even when told—that mergers are risky propositions up until the closing. * * * To attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations, implies that they should not be told about new plants, new products, new managers, or any of the other changes in the life of the corporation.

The second justification for the agreement in principle test, the purported need for a "bright line" rule to provide corporate certainty, touches on matters of more substance. Clear-cut guides to conduct are desirable, but they also have their drawbacks especially where, as in this field, the topography is too uneven to permit the drawing of bright-line rules that serve the statutory objectives. Some measure of uncertainty is inherent in the *Northway* test of materiality because decisions about whether corporate information is material depend on all the circumstances. Any rule that makes a single event (such as the reaching of an agreement in principle) the conclusive determinant of materiality in all cases will either excuse some falsehoods about significant matters or impose liability on account of misstatements of trivial information, a result against which *Northway* cautioned.¹⁴

The third rationale for the agreement in principle test is that disclosure may affect or stifle merger negotiations. This is an important concern, but it does not warrant the conclusion that information is not material prior to an

¹⁴ See Staff of House Comm. on Interstate and Foreign Commerce, 95th Cong., 1st Sess., *Report of the Advisory Comm. on Corporate Disclosure to the Securities and Exchange Commission* 327 (Comm. Print 1977):

Although the Committee believes that ideally it would be desirable to have absolute certainty in the application of the materiality concept, it is its view that such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula. The Committee's advice to the Commission is to avoid this quest for certainty and to continue consideration of materiality on a case-by-case basis as problems are identified.

agreement in principle. As we have explained, companies have no general affirmative duty under the federal securities laws to disclose even material merger negotiations. Even in the face of inquiries, a company generally may remain silent, or say "no comment."¹⁷ Furthermore, even if some facts regarding negotiations are disclosed, many details, including the identity of the other party to the talks and the precise terms discussed, may often remain secret.¹⁸ It is also very possible that fears that accurate disclosure will inhibit negotiations have been greatly exaggerated.¹⁹ But the fundamental point is that the anti-

¹⁷ It has been suggested that a "no comment" response is impractical. In *Flamm*, slip op. 16-17, the Seventh Circuit stated that since companies may ordinarily wish to deny false rumors of corporate developments, a "no comment" response will effectively confirm that there are developments. But this dilemma is not resolved by allowing a company to make false denials of corporate developments. If false denials were permitted, then truthful denials would lose meaning, because the market would know that the company could be lying. For the market to have confidence in corporate statements, a consistent policy of truthfulness about material matters is essential (see note 20, *infra*).

¹⁸ For example, the instructions to Commission Schedule 14D-9 expressly draw a distinction, for purposes of disclosure of merger negotiations in Item 7 of that Schedule, between disclosing the fact of negotiations and disclosing the parties to the negotiations and the terms being discussed. The latter need not be disclosed if it would harm the negotiations. The limitations on the scope of disclosure required under Schedule 14D-9 were adopted in response to industry concerns that too much disclosure would stifle negotiations. See Exchange Act Release No. 6,158, 18 S.E.C. Dkt. 1053, 1070 (Nov. 29, 1979). Although this degree of disclosure may often also be sufficient for purposes of the antifraud provisions of the securities laws, it should be noted that under some circumstances additional disclosure might be necessary under those provisions. *Ibid.*

¹⁹ One recent commentator notes that "[t]he notion that early disclosure prevents mergers has never been empirically confirmed. * * * Courts have relied solely on assertions of the business community and representatives of the stock market." Comment, *Disclosure of Preliminary Merger Negotiations Under Rule 10b-5*, 62 Wash. L. Rev. 81, 94 (1987) (footnote omitted).

fraud provisions of the federal securities laws, and the philosophy on which they are based, simply do not permit corporate managements to utter materially misleading statements in order to achieve the greater good for some (or even all) shareholders.²⁰ No rule of law condones fraud simply so that other corporate goals might thereby be served.²¹

C. This Case Should Be Remanded For An Assessment of Materiality Under the Correct Standard

While the decision below correctly rejected the agreement in principle test, it did not evidence the careful inquiry we have described. Instead, it suggested that "information concerning ongoing acquisition discussions becomes material *by virtue of the statement denying their existence*" (Pet. App. 13a (emphasis in original)), and

²⁰ Such misstatements also impair capital markets. As the Commission stated in *In re Carnation Corp.*, 33 S.E.C. Dkt. at 1030:

The importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be over-emphasized. To the extent that investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike.

²¹ The Seventh Circuit has suggested that a corporation may have a duty to its shareholders to remain silent as to the state of merger negotiations. See *Flamm*, slip op. 12-15. The court reasoned that while some shareholders may, as a result of corporate silence, sell their stock at less than they might have received if they had known of the prospective merger, the silence helps to assure that the shareholders overall will benefit from a successful merger. But where silence would be fraudulent, such as where the company is trading in its own securities, the company cannot remain silent. And, if the company chooses to speak, basic principles prohibit it from lying about material events and thereby misleading both shareholders and the trading market. Cf. 2 F. Harper, F. James & O. Gray, *The Law of Torts* § 7.2 at 388 (2d ed. 1986) (footnote omitted) (even at common law, "[a] plaintiff is within the scope of the duty not to deceive where defendant intended him to act on the misrepresentation whether or not defendant's motives were benign or altruistic.").

that "once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material, because they make the statement made untrue" (*id.* at 14a-15a (footnote omitted)). This apparent equating of falsehood and materiality has no basis under *Northway* and would appear to render any false statement, regardless of how trivial, per se material.²² Because the court of appeals confused the falsity of a statement with the materiality of negotiations, it failed to specify the factors to be considered in assessing materiality and failed to apply the correct standard to the facts of this case. Accordingly, the judgment below should be vacated and the case should be remanded for a determination of materiality on the basis of the principles set forth above.

We believe there is sufficient evidence for a trier of fact to find that at the time of the second and third statements, the events had created a significantly greater possibility of a value-affecting acquisition than investors had reason to expect on the basis of publicly available information. We therefore disagree with the district court's conclusion that those events were immaterial as a matter of law and with its grant of summary judgment as to Basic's second and third public statements. Reviewing the events in the months prior to the two statements (Pet. App. 100a), the district court concluded "that, considered most favorably for the plaintiffs, they represented preliminary merger discussions between Combustion and Basic." The possibility of a merger between Combustion and Basic was being seriously discussed at the highest levels of the two companies. Basic's chairman (and chief executive officer) was personally involved in discussions with a senior officer of Combustion, who in turn, the district court found, was keeping his superiors advised of the state of discussions (*id.* at 70a-71a). Far from

²² The court may not have intended such a result. One of the judges on the *Basic* panel, concurring in the denial of rehearing en banc, expressly took the position that the decision does not stand for this result (Pet. App. 145a-146a).

rebuffing Combustion's overtures, Basic at least entertained the prospect of a merger, the companies had begun to discuss price (*id.* at 77-78a, 101a), and Basic provided confidential financial information to Combustion to assist it in preparing an offer (*id.* at 71a-73a, 81a-85a, 101a).

Basic's first statement was issued approximately fourteen months before a merger agreement was reached and almost a year before the second statement. The courts below viewed the evidence of merger activity prior to the first statement differently. The district court indicated that, prior to that statement, Combustion on several occasions expressed interest in acquiring Basic (Pet. App. 50a, 53a-55a), but that there was no evidence that other conversations between the companies, alleged by plaintiffs to be merger discussions, related to an acquisition rather than to other business (*id.* at 48a, 55a-56a). In the district court's view, Basic had expressed no reciprocal interest in a merger at that point (*id.* at 55a) and was, in fact, not interested (*id.* at 45a), although it gave Combustion confidential financial information that could be found to have been given "in connection with" Combustion's expression of interest (*id.* at 52a).²⁵ This description of the events would support a conclusion that although, like many companies at most times, Basic was a subject of some acquisition interest, events had not yet significantly increased the possibility that the company would be acquired.

The court of appeals read the record on the motion for summary judgment differently. It said that in September 1976, a year before the first statement, Basic's chairman had been approached by Combustion's vice president to discuss the possibility of a merger (Pet. App. 3a-4a), and that the companies had "numerous" telephone con-

²⁵ The court also stated that Basic's internal discussions of Combustion's interest in acquiring Basic took place in the context of discussing several companies' interest in Basic (Pet. App. 45a-46a, 51a), and that Basic met with its investment bankers to discuss possible acquisitions by Basic of two companies, not Combustion's possible acquisition of Basic (*id.* at 56a).

versations and meetings to discuss a possible merger (*id.* at 4a). The court also stated that Basic gave Combustion confidential financial information, that Basic's lawyers discussed a possible Combustion bid, and that Basic and its investment bankers discussed preparation of an evaluation of Basic to use in merger negotiations (*id.* at 4a-5a). On remand, the court of appeals will have to determine whether summary judgment as to the first statement was warranted under the proper standard of materiality.

II. RESPONDENTS WERE ENTITLED TO A REBUTTABLE PRESUMPTION OF RELIANCE UNDER THE FRAUD ON THE MARKET THEORY

The court of appeals in this case correctly held, as has every other court to consider the issue,²⁶ that a plaintiff alleging fraud under Rule 10b-5 may, in circumstances where a materially false or misleading corporate statement has been disseminated into the trading market, invoke a rebuttable presumption of reliance upon the integrity of the market price.

Reliance is generally part of the logical chain needed to establish that a defendant's misrepresentation or omission was the cause in fact of the plaintiff's injury. See

²⁶ See *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986); *Harris v. Union Electric Co.*, 787 F.2d 355, 367 & n.9 (8th Cir. 1986), cert. denied, No. 85-2036 (Oct. 6, 1986); *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), cert. denied, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), cert. denied, 459 U.S. 1102 (1983); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), vacated as moot after cert. granted, 459 U.S. 1027 (1982); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980); *Blackie v. Barrock*, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). See also *Flamm v. Eberstadt*, *supra*; *Wachovia Bank & Trust Co. v. National Student Marketing Corp.*, 650 F.2d 342, 358 (D.C. Cir. 1980), cert. denied, 452 U.S. 954 (1981); *In re LTV Securities Litigation*, 88 F.R.D. 134, 142 (N.D. Tex. 1980); *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982).

List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965). Although the requirement is ordinarily met by showing the plaintiff's actual subjective reliance on the defendant's statement (see 3 L. Loss, *Securities Regulation* 1430-1432 (2d ed. 1961)), courts have held that proof of such direct reliance is not necessary in certain cases, including those alleging a "fraud on the market."

The fraud on the market theory rests on two propositions (see Pet. App. 17a): that in an active secondary market the price of a company's stock is determined by all material information available regarding the company and its business;²⁵ and that investors rely on the integrity of market prices when making investment decisions. See, e.g., *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986); *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976). These propositions together establish that such investors rely, albeit indirectly, on material misrepresentations concerning actively traded securities (Pet. App. 17a). See *Blackie v. Barrack*, 524 F.2d at 907.²⁶

Courts could have placed on the plaintiff the burden of demonstrating in a particular case that the market price

²⁵ Thus, the price of a stock may reflect, and be distorted by, any material misrepresentation about the company. See, e.g., *Peil v. Speiser*, 806 F.2d at 1160-1161; *Blackie v. Barrack*, 524 F.2d at 906; *In re LTV Securities Litigation*, 88 F.R.D. at 143-144; Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143, 1154-1156 (1982). See also *Flamm*, slip op. 19; *Seaboard World Airlines, Inc. v. Tiger International, Inc.*, 600 F.2d 355, 361-362 (2d Cir. 1979).

²⁶ To rebut the presumption, a defendant must show either that the market price did not reflect the corporate statements, or that the plaintiff did not rely on market price in trading (Pet. App. 18a n.6). See *Blackie v. Barrack*, 524 F.2d at 906; *Peil v. Speiser*, 806 F.2d at 1161. Some courts have extended the fraud on the market theory to initial public offerings. See, e.g., *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d at 1330; *Shores v. Shlar*, 647 F.2d at 462; *Arthur Young & Co. v. United States District Court*, 549 F.2d 686 (9th Cir.), cert. denied, 434 U.S. 829 (1977). That issue is not present in this case and we do not address it.

reflected corporate misstatements and that he in fact relied on the integrity of the market price. In practice, however, every court that has adopted the fraud on the market theory in the context of an active secondary market has also applied a presumption in favor of the plaintiff as to these matters. Three well-founded reasons support this approach. First, the empirical and common-sense evidence in support of the two propositions comprising the theory is so strong that it is sensible, as a matter of logic and judicial efficiency, to apply a rebuttable presumption that the propositions are true. Second, the presumption facilitates important policy objectives underlying the federal securities laws.²⁷ Finally, the presumption relieves the plaintiff of an evidentiary burden it is not practical to place on him.

Studies have firmly established that active secondary markets are efficient transmitters of corporate information and that prices in such markets reflect that information.²⁸ In *In re LTV Securities Litigation*, 88 F.R.D. 134, 135, 144 (N.D. Tex. 1980), the court summarized the point, saying that numerous economic studies demonstrate that "the market price of [widely-followed securities of larger corporations] reflects all available public information—and hence, necessarily, any material misrepresentations as well." Many other courts have accepted the overwhelming empirical evidence that

²⁷ Presumptions are often applied to aid favored contentions or handicap disfavored ones. For example, "[a] classic instance [of a policy-based presumption] is the presumption of ownership from possession, which tends to favor the prior possessor and to make for the stability of estates." C. McCormick, *Evidence* § 343, at 968 (3d ed. 1984) (footnote omitted).

²⁸ See, e.g., E. Fama, *Foundations of Finance* 320-382 (1976); J. Lorie & M. Harriston, *The Stock Market* 70-97 (1973); Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 551 (1984); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 Stan. L. Rev. 1031, 1034-1057 (1977).

the prices of securities traded in active secondary markets reflect information disseminated into those markets.²⁹

Courts have similarly accepted the common-sense observation that most investors rely on the integrity of the market in making trading decisions.³⁰ As one court has noted, "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982). The fact that investors are in the market at all is evidence that they rely on the assumption "that the market is not being manipulated as a result of anybody's false statement or misleading omission." *Ibid.*

The presumptions underlying the fraud on the market theory also promote important policies under the federal securities laws. The federal securities laws were adopted in large measure to restore integrity to, and investor con-

²⁹ See, e.g., *Flamm*, slip op. 19; *Peil v. Speiser*, 806 F.2d at 1163; *Harris v. Union Electric Co.*, 787 F.2d at 367 & n.9; *Seaboard World Airlines, Inc. v. Tiger International, Inc.*, 600 F.2d at 361-362; *Blackie v. Barrack*, 524 F.2d at 907; *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. at 538.

³⁰ Petitioners contend (Pet. 26-27) that even if a presumption of reliance is appropriate in a fraud on the market case brought by purchasers, it is inappropriate in a case brought by sellers. They argue that, even assuming persons might make decisions to purchase securities in the open market on the "relatively common basis" of market price, there is no reason to make the same assumption regarding decisions to sell, which might be made for other reasons, the most obvious being a need for cash. But petitioners point to no authority for the proposition that sellers are oblivious to price. In fact, at least one case did involve sellers. *Schlanger v. Four-Phase Systems, Inc.*, 555 F. Supp. at 535. See, generally Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. at 1153-1156. While sellers may have various reasons for selling, the vast majority rely on price to decide when and what security to sell. An investor needing cash, for example, would presumably evaluate the stock's market price in relation to other options, including borrowing money using the stock as collateral.

fidence in, the securities markets. The House Report recommending enactment of the Securities Exchange Act notes that honest corporate information is essential to assure that the markets reflect the "real value" of securities (H.R. Rep. 1383, 73d Cong., 2d Sess. 11 (1934) (emphasis added)):

No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that *competing judgments of buyers and sellers as to the fair price of a security brings [sic] about a situation where the market price reflects as nearly as possible a just price.* Just as artificial manipulation tends to upset the true function of an open market, so *the hiding and secreting of important information obstructs the operation of the markets as indices of real value.*

A fundamental premise of the Securities Exchange Act is, in short, that the markets are affected by information, so that "[t]here cannot be honest markets without honest publicity" (*ibid.*). An equally fundamental premise is that investors rely on the integrity of markets. A defendant contending that these basic premises are not true in a particular case should bear the burden of proving it.

The courts have viewed the fraud on the market theory, and the accompanying presumption of reliance, as a means of furthering the statutory goal of ensuring honest securities markets. See, e.g., *Lipton v. Documation, Inc.*, 734 F.2d 740, 748 (11th Cir. 1984), cert. denied, 469 U.S. 1132 (1985) ("The theory thus actually facilitates Congress' intent . . . by enabling a purchaser to rely on an expectation that the securities markets are free from fraud."); *In re LTV Securities Litigation*, 88 F.R.D. at 145. To the extent that private securities fraud actions may be prosecuted more efficiently by adoption of the fraud on the market theory and its presumption of

reliance, the enforcement of the securities laws, and the underlying goal of honest markets, are furthered.³¹

Finally, placing the burden of proof on a plaintiff alleging fraud on the market would impose an unrealistic evidentiary burden. See *Lipton v. Documation, Inc.*, 734 F.2d at 743; *Panzirer v. Wolf*, 663 F.2d at 367; *Blackie v. Barrack*, 524 F.2d at 907; *Rosenberg v. Digilog, Inc.*, 648 F. Supp. 40, 43 (E.D. Pa. 1985).³² Of course, a plaintiff could offer evidence that he relied on the integrity of the market in making his investment decision. But proving affirmatively that the market price of a security was affected by corporate misstatements may be difficult. A plaintiff might have to present extensive and hard to obtain evidence as to who in fact traded in the stock following the corporate statement, how many of those traders were in fact aware of the statement and whether they in fact relied on the statement in making their trad-

³¹ This Court has "repeatedly * * * emphasized * * * that implied private actions [under Rule 10b-5] provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

³² Petitioners argue (Pet. 22) that the presumption has been applied improperly to facilitate class certification. The district court in this case, however, expressly disclaimed any intention of seeking to facilitate class actions (Pet. App. 129a). The court of appeals, although recognizing that the presumption does facilitate class actions, did not use that circumstance to justify its decision. Contrary to petitioners' assertion, the presumption of reliance in a fraud on the market case is grounded on characteristics of the securities markets and investor behavior, as well as on policy objectives, that are equally applicable to individual and class actions. See Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 Geo. Wash. L. Rev. 627, 645-653 (1982); Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. at 1154-1156.

ing decisions. Cf. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970) (misleading proxy statements).³³

The fraud on the market theory merely accommodates these various concerns by recognizing the obvious, that market prices generally reflect corporate information and that investors generally rely on the integrity of the market price, and by relieving plaintiffs of the need to reprove these matters in each case.³⁴ The theory does not dispense with the requirement of reliance in Rule 10b-5 cases but places the burden on the defendant to prove that a particular case is atypical. In so doing, the fraud on the market theory facilitates securities fraud actions by injured investors, allows those actions to be prosecuted with greater judicial efficiency, and promotes important goals of investor protection under the federal securities laws.

³³ In *Mills*, this Court adopted a presumption that a misleading proxy statement caused injury alleged to have resulted from a shareholders' vote in favor of a merger. The Court rejected the argument that a plaintiff should be required to prove that the proxy statement had a decisive effect on the vote. So long as the misstatements were material, and the proxy solicitation was an "essential link" in effecting the merger, this Court held, "a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress * * *" (396 U.S. at 385). Such a result, the Court said, "will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice * * *" (*ibid.*).

³⁴ While the fraud on the market theory permits a presumption that material misstatements affected the market price, the plaintiff retains the burden of establishing, in a manner that will vary from case to case, the amount of his damages.

CONCLUSION

The judgment of the court of appeals should be affirmed in part and vacated in part, and the case should be remanded for further proceedings.

Respectfully submitted.

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AMICUS CURIAE

BRIEF

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In the Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ET AL., PETITIONERS

v.

MAX L. LEVINSON, ET AL., RESPONDENTS

On Writ of Certiorari to the United States
Court of Appeals for the Sixth Circuit

**MOTION FOR LEAVE TO FILE BRIEF FOR THE
AMERICAN CORPORATE COUNSEL ASSOCIATION
AS AMICUS CURIAE AND BRIEF AS AMICUS CURIAE
IN SUPPORT OF PETITIONERS**

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**MOTION FOR LEAVE TO FILE BRIEF FOR THE
AMERICAN CORPORATE COUNSEL ASSOCIATION
AS AMICUS CURIAE**

Pursuant to Rule 36 of the Rules of this Court, the American Corporate Counsel Association ("ACCA") requests leave to file the accompanying brief as amicus curiae in support of petitioners. The attorneys for petitioners have consented to the filing of this brief. Consent has not been received from the attorney for respondents.

ACCA is a national bar association, with 26 local chapters across the country, that is devoted exclusively to the professional activities of attorneys on the legal staffs of corporations and other business entities in the private sector. ACCA has approximately 7000 members employed as corporate counsel by some 3500 organizations. Many of these members are the chief legal officers of their client corporations.

In their professional activities, members of ACCA are confronted on a regular basis with issues concerning the disclosure of contingent and inchoate events, including possible future mergers or other business developments. ACCA members are intimately involved in giving legal advice and formulating company policy on disclosure matters and in advising management on pending litigation.

Corporate counsel and their management have a substantial interest in the formulation of materiality standards that provide clarity and certainty for corporate decision-making and in avoiding overbroad class action rules that eliminate traditional elements of a Rule 10b-5 cause of action.

ACCA believes that the accompanying amicus curiae brief will be of assistance to the Court in its consideration of this case. The brief analyzes the issue of the disclosure of preliminary merger negotiations in the broader context of contingent and inchoate information generally and discusses the difficult practical problems that disclosure of such information poses for corporate counsel and management. In addition, the brief argues against the expansion of class action damages liability for a number of reasons that are familiar to corporate counsel. Accordingly, the brief should offer the Court a broader perspective than the parties can be expected to provide.

For the foregoing reasons, the motion of the American Corporate Counsel Association for leave to file the accompanying brief as amicus curiae in support of petitioners should be granted.

Respectfully submitted.

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AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

INTEREST OF THE AMICUS CURIAE

The American Corporate Counsel Association is a national bar association devoted exclusively to the professional activities of attorneys on the legal staffs of corporations and other business organizations in the private sector. The Association and its interest in this case are fully described in the accompanying motion for leave to file this brief as amicus curiae in support of petitioners.

INTRODUCTION AND SUMMARY OF ARGUMENT

This case concerns the correctness of the Sixth Circuit's use of the "fraud on the market" theory to sustain a Rule 10b-5 class action for damages and its conclusion that denials of preliminary merger discussions are per se material regardless of whether the prospect of a merger is highly contingent and uncertain. As we demonstrate below, the court of appeals' treatment of these issues was in error for a number of reasons.

But the fundamental unsoundness of the Sixth Circuit's approach is most evident in the incongruous and wholly unjustified results that it produces. There is no claim in this case that the defendant company or its officials made profits or avoided losses by trading in company stock during the period of the merger discussions, and therefore the special policies and rules applicable to "insider trading" do not pertain here. There also is no evidence that petitioners' statements were made for any reason other than a legitimate business purpose—to preserve the confidentiality of preliminary merger discussions for the benefit of the company's shareholders. In addition, there is no indication that the stock market was misled by petitioners' statements or that shareholders who sold their stock during this period were damaged by those statements. On the contrary, as is frequently the case, the stock market appears to have had other sources of information, and the stock price rose despite Basic's statements. The Sixth Circuit's decision thus has applied Rule 10b-5 to conduct that does not even approach fraud in any meaningful sense.

In adopting an erroneous standard of materiality, the Sixth Circuit has deprived corporate management and its advisors of a workable guide as to when preliminary merger discussions must be disclosed. Furthermore, in dispensing with proof of the traditional elements of reliance, causation, and injury, the Sixth Circuit has fundamentally altered the nature of Rule 10b-5 litigation. First, it has permitted a mammoth class action to proceed that could not properly be maintained under traditional principles. And second, it has converted Rule 10b-5 into a mechanism for redistributing tens or hundreds of millions of dollars from the company's innocent shareholders, who were not unjustly enriched by the alleged misstatements, to another group of investors who, under the decision below, would not need to prove that they were in fact injured as a result of those statements. Whatever administrative or equitable remedies might be appropriate to encourage greater corporate candor, nothing can justify

the punitive and economically senseless private damages class action that the court of appeals has countenanced in this case.

ARGUMENT

I. THE "FRAUD ON THE MARKET" THEORY ENDORSED BY THE SIXTH CIRCUIT UNJUSTIFIABLY ELIMINATES ESSENTIAL ELEMENTS OF THE RULE 10b-5 CAUSE OF ACTION, CONFLICTS WITH ECONOMIC THEORY, AND INFLICTS DISPROPORTIONATE PENALTIES.

Respondents, a class of all sellers of stock in petitioner Basic Inc. during the 14-month period ending in December 1978, seek damages under Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) and SEC Rule 10b-5, alleging that Basic made materially misleading statements concerning the existence of certain merger negotiations. A key question for decision is whether the Sixth Circuit improperly presumed reliance, causation, and damages in order to permit respondents' fraud claim to go forward as a class action.

The case arises out of a merger between Basic and Combustion Engineering, Inc., that had been preceded by repeated solicitations by Combustion, lengthy discussions between the companies, and persistent market rumors. Shortly after the supposedly secret merger discussions began, the stock market reacted. Basic's stock price and trading volume jumped amid rumors of merger negotiations. When a company official was asked about the rumors and stock activity, he responded in an attempt to preserve the confidentiality of the preliminary discussions by denying awareness of any "significant corporate developments" that would account for the price and volume movements in Basic stock. The market appears not to have been affected by these or subsequent denials; the reports of merger negotiations continued, and Basic's stock and trading volume continued to rise. See Pet. App. 5a-8a. There is no indication that Basic or its officials were trading in the company's stock during this period.

Respondents brought this action after the merger negotiations finally reached fruition, contending that Basic's misstatements had misled them into selling their stock at prices that were artificially depressed. If this matter were tried as a conventional Rule 10b-5 lawsuit, the members of the plaintiff class would have substantial difficulty proving the elements of their claim. Few, if any, would be able to demonstrate that they relied on Basic's statements in the face of contrary market reports and rising stock prices. And even if some traders could prove reliance, it is doubtful that any could show that the prices at which they sold Basic stock were artificially depressed by the company's statements. It appears from the evidence recited by the court of appeals that the stock price throughout the period reflected whatever merger price was then under discussion, discounted for the risk in all merger discussions that an agreement might never be reached. Pet. App. 6a-8a & nn. 2, 3.

In any event, the questions of reliance and causation present individual issues. As in any transaction, each trader has personal reasons for selling Basic stock. The mix of information and motives that might have affected the stock price and influenced individual plaintiffs changed from day to day. Indeed, the district court acknowledged that if each member of the class were required to show reliance on the company's representations, "questions affecting individual members probably would predominate over common questions such that the class certification would be improper." Pet. App. 16a. To overcome that barrier, the district court invoked the doctrine of "fraud on the market":

To circumvent what the district court perceived to be a barrier to class actions in 10b-5 cases, it applied a presumption of reliance so that common questions predominated and the class was appropriately certified.

Ibid.

The Sixth Circuit affirmed, agreeing that resort to this legal *deus ex machina* was warranted. The court of appeals reasoned that reliance, which it described as "the element of a Rule 10b-5 action that establishes the causal nexus between the defendant's wrongful conduct and the plaintiff's injuries" (Pet. App. 16a-17a), should be presumed under the "fraud on the market" theory because "proof of actual reliance would be impractical or impossible" (*ibid.*) and because Basic's stock was traded on the New York Stock Exchange. Assuming, without any record support, that Basic's statements had distorted the price of the company's stock throughout the entire 14-month class period, the court concluded that "[w]hen a plaintiff purchases on the impersonal market after * * * misrepresentations are made, the [fraud on the market] theory presumes that he relied on the supposed integrity of the market price, and thus indirectly on the misrepresentation." *Ibid.*

In presuming reliance, causation, and damages to facilitate the maintenance of an otherwise improper class action, the courts below seriously erred. As demonstrated in this brief, the "fraud on the market" theory improperly eliminates established elements of the Rule 10b-5 cause of action, conflicts with common sense and principles of economic theory, inflicts disproportionate penalties, and opens the door to windfall recoveries and coercive class action settlements. If such a radical departure from traditional legal standards is to be countenanced, it is Congress that should so declare.

A. The Sixth Circuit's Formulation Of The "Fraud On The Market" Theory Improperly Eliminates Settled Requirements Of A Rule 10b-5 Cause Of Action.

To prevail on a claim of fraudulent misrepresentation, plaintiffs have traditionally been required to prove reliance, causation, and damages. In summarily eliminating those elements to facilitate the maintenance of this class action, the Sixth Circuit lost sight of the fact that an action under Rule 10b-5 is, at bottom, a *fraud* action.

Section 10(b) is "directed at fraud 'in connection with the purchase or sale' of securities." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975). It is therefore essential to bear in mind the elements of "misrepresentation and deceit, to which a claim under Rule 10b-5 certainly has some relationship." *Id.* at 744. This Court's decisions have repeatedly held that efforts to expand civil liability under Rule 10b-5 may not be undertaken without reference to those traditional elements of a cause of action for fraud.

The Court has held, for example, that a Rule 10b-5 claim requires proof of deception (*Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977)), that any deceptive statement must be material (*TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)), and that a defendant must have acted with scienter, defined as intent to deceive (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)). Likewise, the Court has held that a plaintiff suing under Rule 10b-5 must "establish the requisite element of causation in fact" as well as "damages." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154 (1972). While the Court has permitted litigants to resort to a "presumption" of reliance in cases involving total "non-disclosure" of material facts, in view of the impossibility of proving positive reliance when there has been no disclosure, it has never suggested that reliance may be dispensed with in a case such as this, involving alleged misrepresentations of material fact. See *Hochfelder*, 425 U.S. at 206, quoting the legislative history of the civil liability provisions of the Securities Exchange Act: "[T]he burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage."

Accordingly, it was wholly improper for the courts below to presume without proof the elements of reliance, causation, and damages, merely to facilitate the maintenance of a class action proceeding. See *List v. Fashion*

Park, Inc., 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965). A rule that effectively "do[es] away with the reliance requirement * * * threatens to turn all of Rule 10b-5 into a scheme of investor insurance." *Shores v. Sklar*, 647 F.2d 462, 486 (5th Cir. 1981) (en banc) (dissenting opinion), cert. denied, 459 U.S. 1102 (1983).

B. The "Fraud On The Market" Theory Applied By The Sixth Circuit Conflicts With Modern Economic Principles.

There is a compelling practical reason to withhold endorsement of the "fraud on the market" theory in this case. Not only is it inconsistent with prior decisions requiring proof of reliance and causation, but it also clashes with common sense and established economic principles. Indeed, it is fair to say that the Sixth Circuit's "fraud on the market" approach completely ignores the development of modern stock-market theory over the past two decades.

The Sixth Circuit described the "fraud on the market" theory as follows (Pet. App. 17a):

When a defendant is shown to have made a material public misrepresentation that, if relied on directly, would fraudulently induce an individual to misjudge the value of the stock, the theory presumes that some investors did so rely and that the market price is distorted.

Thus, the Sixth Circuit assumed that the stock market is misled by any statement that could mislead an individual investor, and that this "distortion" of the market constitutes an appropriate measure of damages for all who purchase or sell securities at that "distorted" price. As a result, proof of individual reliance, causation, and damages is unnecessary. Apparently, in the Sixth Circuit's view, a company that makes an overly optimistic representation is presumptively liable to everyone who buys stock thereafter; a company that makes an overly

pessimistic representation is liable to everyone who sells stock thereafter. The market is presumed to be "distorted" until the issuer of the statement corrects it.

This far-reaching approach, which has never been accepted by Congress or this Court, rests on a simplistic and completely erroneous view of the operation of the stock market. While the "fraud on the market" rationale is garbed in the rhetoric of modern "efficient market" theory, it is in fact utterly inconsistent with the teachings of that theory.

Efficient market theory holds that the price of a stock, traded on an efficient market, incorporates all public (and at least some non-public) information about that stock. According to this theory, as new information comes into the market, the price of the stock quickly fluctuates to reflect that information. That is why it is so difficult to predict future stock prices and so difficult for even the best-informed investors to outperform the market in the long run. See J. Lorie & M. Hamilton, *The Stock Market: Theories and Evidence* 70-110 (1973); E. Fama, *Foundations of Finance* 133-176 (1976); R. Posner, *Economic Analysis of Law* 324-326 (1977). Whatever the merit of this theory, it plainly does not support the Sixth Circuit's ruling here.

Contrary to the court of appeals' assumption, it does not follow from efficient market theory that the market price is distorted by any misstatement that might be material to an individual average investor. The stock market cannot be equated with a single investor. Rather, the market embodies the collective wisdom of thousands of traders, with prices typically determined by the bargains struck between the most sophisticated of those traders. See *Metlyn Realty Corp. v. Esmark, Inc.*, 763 F.2d 826, 835 (7th Cir. 1985) ("[t]he price of an actively traded stock reflects the value placed on it by the professional investors who follow a firm closely"). Such traders take into account *all* information about a stock, but reject much of it as inaccurate, unreliable, or con-

trary to better intelligence. See E. Fama, *supra*, at 377 ("the market is not misled" by changes in accounting technique).

The other basic feature of an efficient market is that the market is quick to correct its mistakes. If the price of a stock becomes distorted, traders frequently step in to buy the undervalued stock or sell the overvalued stock until the proper price is restored. See T. Copeland & J. Weston, *Financial Theory and Corporate Policy* 211 (1979) ("[c]apital market efficiency relies on the ability of arbitrageurs to recognize that prices are out of line and to make a profit by driving them back to an equilibrium value"); Report of the SEC Office of the Chief Economist, *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?* (Feb. 24, 1987), at 5 ("pre-bid market activity is inevitable. * * * [I]t makes capital markets more efficient [and] aligns actual stock prices with their theoretically correct values"). Spurred by the incentive to maximize profits or minimize losses, sophisticated traders compete intensively to ferret out information about underlying events and values. As the SEC's Chief Economist recently commented:

[A]n army of traders, arbitragers, and stock analysts is quick to spot unusual activity of corporate executives, the calling and cancelling of meetings and other seemingly insignificant corporate developments that might give a clue to an upcoming major development. * * * Experts closely monitor such things as which brokerage firm is doing the heaviest buying and selling of a particular stock.

Id. at 6.

The SEC Report further observed that this process operates with particular astuteness in discovering information about takeovers:

[I]t's not hard for all sorts of people to deduce that takeover action is about to occur in a stock. Computers are a big help here. Accumulation is instant

news; so is unusual volume. Connected by a national network of direct phone lines, smart traders . . . talk to one another and to brokers constantly.

Id. at 6-7. Thus, as supposedly secret takeover plans move from possibility to concrete reality, stock prices and trading volume rise:

Trading volume on the day of public announcement rises to 20 times its historical daily average. It is five times normal the day before the announcement and triple two days before the announcement. . . . These statistics tell a story of an active market for information about impending takeover bids.

Id. at 33.

The present case bears out these findings by the SEC's Chief Economist about the general characteristics of the takeover market, rather than the assumptions underlying the Sixth Circuit's "fraud on the market" theory. Here, the market was awash with reports that Basic was engaged in merger negotiations. These reports persisted despite Basic's statements, and Basic's stock price and trading volume continued to rise. There is no indication of a market response to Basic's statements. Rather, it appears, the market had discerned the truth about the merger talks and refused to credit Basic's denials. Pet. App. 5a-8a.

In these circumstances, the Sixth Circuit committed a fundamental error in concluding that a statement that would "fraudulently induce an individual to misjudge the value of the stock" supports a presumption that "the market price is distorted." Pet. App. 17a. Not only is the presumption unsupported by economic theory, but it directly contradicts the factual record in this case. It was therefore improper to certify a class of all sellers of Basic stock over a 14-month period, when there was no proof that the stock price was ever distorted by Basic's statements (let alone distorted throughout the class period) and no proof that common issues would predominate.

C. The "Fraud On The Market" Theory Endorsed By The Sixth Circuit Rests On An Erroneous View Of The Scope Of Liability Under Rule 10b-5.

Plaintiffs' "fraud on the market" class action suffers from another fundamental defect. Petitioners here were neither purchasers nor sellers of any securities. Yet the court of appeals assumed that all traders in the market who could allege that the market price of their investments was affected by petitioners' statements could recover their market losses from petitioners. Although a number of lower courts have accepted this conclusion, we submit that such a sweeping and open-ended liability is completely at odds with the congressional scheme. Damages in a market fraud class action should be based on the defendant's illicit profits or avoided losses, rather than on the highly conjectural damages (or unrealized gains) of traders in the company's stock.

Section 10(b) of the Securities Exchange Act does not federalize the entire law of fraud or confer a cause of action to recover general market losses based on erroneous press releases. The section is expressly limited to fraudulent activities "in connection with the purchase or sale of any security." A natural reading of those words would limit the coverage of Rule 10b-5, and the liability imposed thereunder, to fraudulent activities in connection with securities transactions engaged in by a defendant and any co-conspirators. See *Hochfelder*, 425 U.S. at 199 (Rule 10b-5 must be interpreted to avoid a "gloss to the operative language of the statute quite different from its commonly accepted meaning").

This reading is consistent with the original purpose of Rule 10b-5. As this Court has noted, "Rule 10b-5 was adopted in order to close 'a loophole in the protections against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.'" *Blue Chip Stamps*, 421 U.S. at 736 n.8 (emphasis added). Moreover, proponents of implying

a private cause of action under Section 10(b) relied heavily on Section 29(b) of the 1934 Act, 15 U.S.C. § 78cc(b), which provides that a contract made in violation of any provision of the Act is voidable at the option of the deceived party. See *Blue Chip Stamps*, 421 U.S. at 735. That justification is completely absent when a defendant has not entered into any securities transactions affected or tainted by a violation of the statute, so that there are no unjust profits to be disgorged or contracts to be voided.

There are additional reasons for favoring a construction of Rule 10b-5 that would limit liability to persons involved in securities transactions. The other principal anti-fraud remedies prescribed in the securities laws contain this very limitation. Thus, Section 11(a) of the Securities Act of 1933, 15 U.S.C. § 77k, applies only to the issuer, its officers and underwriters, and other persons involved in the underwriting process. Similarly, Section 12(2) of the 1933 Act, 15 U.S.C. § 77l, imposes civil liability on any person who "offers or sells a security" by means of a prospectus or oral communication that includes a misstatement or omission of a material fact. These limitations on the *express* rights of action created by Congress have obvious relevance in defining the contours of an *implied* cause of action under Section 10(b), particularly since that section by its terms is restricted to fraud "in connection with the purchase or sale of any security." It would be anomalous indeed to "impute to Congress an intention to expand the [defendant] class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action." *Blue Chip Stamps*, 421 U.S. at 736. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 884 (2d Cir. 1968) (en banc) (Moore, J., dissenting), cert. denied, 394 U.S. 976 (1969) (the securities laws are concerned with purposeful schemes to defraud, not allegedly misleading corporate publicity).

Furthermore, the flow of information to investors would be significantly impaired if the issuance of an arguably misleading press release could result in damages that far exceed any profits the defendant might have made. As Judge Friendly noted in *Texas Gulf Sulphur*, 401 F.2d at 867 (concurring opinion), most corporations would opt for silence rather than take "the risk that a slip of the pen or failure properly to amass or weigh the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers." See also Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611, 640 (1985):

We cannot justify [fraud on the market damages] by saying * * * that the excessive remedy promotes desirable unconditional deterrence. * * * [A] firm that discloses information in the aftermarket as it goes along inevitably takes the risk of excessive optimism and excessive pessimism. A rule that penalizes excesses in either direction would lead to quiet, not (necessarily) to an increase in the world's portion of truth. Investors would not want a rule that promoted silence whenever possible.

Where a corporation has been trading in its own securities and has been enriched by its "fraud," the disgorgement remedy is consistent with these concerns and with the express statutory language, because damages would be based upon a defendant's ill-gotten gains "in connection with the purchase or sale of" securities. Imposition of damages liability under Rule 10b-5 makes little sense, by contrast, where a defendant is neither a purchaser nor a seller of securities. (The Rule 10b-5 remedy is supplemented, of course, by the full panoply of civil and criminal remedies available to the SEC and the Department of Justice to enjoin and punish those who make materially false statements to the public securities markets, see, e.g., 15 U.S.C. §§ 78u and 78aa.)

D. The Sixth Circuit's "Fraud On The Market" Theory Leads To Speculative And Disproportionate Damages Awards And To Coerced Settlements.

There is another substantial reason for refusing to adopt a "fraud on the market" approach in securities cases: fundamental fairness. Much like the theory rejected by this Court in *Blue Chip Stamps*, the "fraud on the market" theory leads to damages awards that are "largely conjectural and speculative" (*Blue Chip Stamps*, 421 U.S. at 735) and that are so totally disproportionate to any sensible judgment about appropriate damages liability that Congress could never have intended to authorize them.

Consider, for example, the case of a speech by a corporate official that does not mention tentative plans to sell a key division at a large profit. Six months later, after 10 million shares have changed hands, the division is sold. Thereafter, the company's stock price rises \$20 per share. Under the "fraud on the market" approach, the company—and, in the final analysis, its innocent shareholders—could be liable to sellers of its stock for \$200 million. (Likewise, if a speech or press release were to omit potential bad news, a class of buyers would be able to file a comparable claim.)

Consider next the case of a corporate official who buys 1000 shares of stock for \$10 per share while in possession of material non-public information that is wrongfully withheld. During the course of the next month the company's trading volume is 20 million shares. At the end of the month, the information is released, the stock rises to \$20 per share, and the official sells the previously acquired shares. Under the "fraud on the market" approach, the official could be held liable for \$200 million.

These examples, which are typical of pending class actions across the country, demonstrate that the Sixth Circuit's "fraud on the market" approach yields penalties

grossly out of proportion both to the misconduct at issue and to the measure of damages Congress has prescribed in similar situations elsewhere in the federal securities laws. Indeed, Congress recently added Section 21(d) to the Securities Exchange Act, 15 U.S.C. § 78u(d), to permit the SEC to recover civil penalties for insider trading. Even in connection with that emotion-laden issue, Congress carefully limited recovery to "three times the *profit gained or loss avoided* as a result of such unlawful purchase or sale" (emphasis added). It would be anomalous, to say the least, to punish more harshly those defendants who may have made misstatements but neither bought nor sold for their own accounts. "The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." *Blue Chip Stamps*, 421 U.S. at 748.

The inevitable result of such a liability scheme is coercive settlements. If a defendant cannot defeat a motion for class action certification or obtain summary judgment, the incentive to settle, rather than bear even a small risk that a jury might find liability, is enormous. As the Court noted in *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 476 (1978), "[c]ertification of a large class may so increase the defendant's potential damages liability and litigation costs that he may find it economically prudent to settle and to abandon a meritorious defense." That is especially true in this category of litigation, given the immense damages presumed by the "fraud on the market" theory.

Encouragement of coerced settlements harms all shareholders. The settlement amounts are simply transferred from one set of innocent investors (the corporation's shareholders) to another set of investors, with a large

portion paid for attorneys' fees and other expenses. In addition, there are enormous direct and indirect social costs associated with this process, caused by uncertainty and distortion of management efforts. Over time, and given the diversification of most investors through pension and mutual funds and the like, the only net winners in the process are the lawyers. Under the "fraud on the market" theory, the evils that this Court warned against in *Blue Chip Stamps* are thus realized with a vengeance: "unduly expansive imposition of civil liability" leads "to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers." 421 U.S. at 739.

These concerns weigh heavily against approval of the "fraud on the market" theory endorsed by the Sixth Circuit. If such a draconian remedy is to be fashioned, it should be done by Congress, "after the kind of investigation, examination, and study that legislative bodies can provide and courts cannot." *Diamond v. Chakrabarty*, 447 U.S. 303, 317 (1980). See also *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 646 (1981).

II. THE MATERIALITY STANDARD UNDER RULE 10b-5 DOES NOT REQUIRE DISCLOSURE OF CONTINGENCIES SUCH AS PRELIMINARY MERGER DISCUSSIONS, AND MANAGEMENT'S DECISIONS TO DISCLOSE OR NOT TO DISCLOSE CONTINGENT EVENTS ARE NOT ACTIONABLE WITHOUT PROOF OF FRAUDULENT INTENT.

The second issue before the Court—the legal obligations surrounding disclosure of preliminary merger discussions—is a specific instance of a pervasive problem frequently encountered by corporate management: whether, when, and how to divulge information about contingent and inchoate future events. Developments that may or may not come to pass are a daily fact of corporate life, and so is the need for confidentiality to protect the value of the endeavor. Creating and marketing a new product, forecasting future economic and market trends, and plan-

ning company operations and predicting performance—these and a host of other uncertainties continually confront those who administer the corporate disclosure system. The Court's decision will have important repercussions for innumerable situations far removed from the disclosure of preliminary merger discussions.

A rule of materiality that is not clear or that compels premature disclosures would deprive companies of one of their most valuable commodities—confidential information. Moreover, a broad standard would breed uncertainty and inhibit effective management. For every statement that a company publishes, corporate officials, in consultation with a host of lawyers, accountants, and other advisors, would have to consider whether there is some undisclosed fact concerning a contingent or inchoate event that might have a bearing on what is being said. The complexities and delays involved in that process would be costly and stultifying. And given the potentially catastrophic liability that could result from a disclosure decision that a jury later finds to be inadequate and therefore in violation of the securities laws, companies inexorably would be driven to disclose more information than is legally required—information that it would be in the best interest of the companies and their shareholders to maintain in confidence.

During preliminary merger talks, for example, must a company reveal the existence of discussions when it issues an annual report to stockholders, when it files a periodic report with the SEC, or when it makes a press release or gives an interview to the media? If management previously, and accurately, denied rumors of a possible merger, must it affirmatively make a corrective disclosure if preliminary merger talks subsequently develop? And if it has disclosed merger discussions, is management thereafter obligated to give a blow-by-blow account as the negotiations take their inevitable twists and turns, for either the better or the worse?

More generally, do the federal securities laws require a company to tell the world—including its competitors at home and abroad—that it is researching an important new technology? Under what circumstance is management obligated to disclose that a government investigation is possible or underway? When must management reveal contingent liabilities arising out of unasserted legal claims? And when and how much need be disclosed about asserted claims or pending litigation?

In our economic system, corporate management must be accorded a wide berth to exercise its informed business judgment in deciding whether, when, and how to disclose this kind of information in order to promote the best interests of shareholders. See *Blue Chip Stamps*, 421 U.S. at 759 n.4 (Powell, J., concurring) (“[p]recise factual accuracy with respect to a corporate enterprise is frequently impossible” for matters that do not involve “hard facts,” such as “[t]he outcome of pending litigation, the effect of relatively new legislation, the possible enactment of adverse legislation, the cost of projected construction or of entering new markets, the expenditures needed to meet changing environmental regulations, [and] the likelihood and effect of new competition or of new technology”).

A. The Materiality Standard Governing Disclosure Of Information Concerning Contingencies Should Provide Clear Guidance To Management And Not Inhibit Legitimate Corporate Activities.

Materiality “has become one of the most unpredictable and elusive concepts of the federal securities laws.” *SEC v. Bausch & Lomb Inc.*, 565 F.2d 8, 10 (2d Cir. 1977). “The SEC itself has despaired of providing written guidelines to advise wary corporate management of the distinctions between material and non-material information,” relying instead on an “after-the-fact, case-by-case approach” (*ibid.*). See also Kripke, *Rule 10b-5 Liability and “Material” “Facts”*, 46 N.Y.U. L. Rev. 1061, 1069 (1971).

1. The General Standard Of Materiality.

The general standard of materiality under the federal securities laws is set forth in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). The test under TSC for determining the “significance of an omitted or misrepresented fact” (*id.* at 445) is whether “there is a substantial likelihood” that it “would have assumed actual significance in the deliberations of the reasonable shareholder” because it “significantly altered the ‘total mix’ of information made available” (*id.* at 449).

Where the information at issue involves an uncertain future event, the “traditional rule” is that materiality “will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company[’s] activity.” *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 849. The probability/magnitude test is properly viewed as part of the TSC standard. See, e.g., *Dirks v. SEC*, 681 F.2d 824, 842-843 (D.C. Cir. 1982), rev’d on other grounds, 463 U.S. 646 (1983); *Harkavy v. Apparel Industries, Inc.*, 571 F.2d 737, 741 (2d Cir. 1978).

The probability/magnitude test is a useful elaboration of the more general TSC standard. By itself, however, it is not an adequate rule for determining the disclosability of contingent and inchoate information. The ad hoc balancing of probability and magnitude is too vague and imprecise to provide meaningful guidance to corporate management—particularly when their judgments are reviewed after-the-fact by lay juries in securities fraud litigation. Moreover, the test denies management necessary discretion to regulate disclosures that could be detrimental to proper and desirable corporate activities.

The Court recognized in *TSC* that the disclosure of information that is not sufficiently significant “may accomplish more harm than good” (426 U.S. at 448). As the Court noted, the potential liability for a securities violation “can be great indeed” and, “if the standard of ma-

teriality is unnecessarily low, * * * the corporation and its management [may] be subjected to liability for insignificant omissions or misstatements" (*ibid.*). In addition, "management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking" (*id.* at 448-449). The Court thus was mindful of "the need to avoid the adverse consequence of setting too low a threshold for civil liability" (*id.* at 449 n.10).

In addition to materiality, a duty to disclose must exist before management is required to make disclosure. *TSC* involved a proxy solicitation by management, that is, a focused effort to induce a shareholder response, and the standards utilized by the Court reflected the heightened need for information that applies when management solicits a shareholder response or an investment decision. But in the absence of such circumstances, and in the absence of insider trading or other similar conduct, the governing disclosure standards must derive from the specific disclosure requirements set forth in the federal securities laws and in applicable accounting standards. See *Chiarella v. United States*, 445 U.S. 222, 228 (1980). Such standards furnish concrete guidance on the duty to disclose as applied to matters such as annual reports, earnings releases, and mergers that have been consummated in principle or in a final agreement. Courts should not lightly extend such disclosure obligations, on an unpredictable ad hoc basis under generalized anti-fraud provisions such as Section 10(b), to encompass preliminary merger discussions, unasserted legal claims, or other contingent events.

2. The Proper Materiality Standard For Disclosure Of Information Concerning Contingent And Inchoate Developments.

a. A sound materiality standard for disclosure of information about contingent or inchoate matters should provide clarity, maximize the overall welfare of shareholders, and avoid misleading investors.

First, the materiality test governing disclosure should be clear and workable. As the Court cautioned in *Dirks v. SEC*, 463 U.S. 646, 658 n.17 (1923), a standard that is "inherently imprecise * * * prevents parties from ordering their actions in accord with legal requirements." It "is essential * * * to have a guiding principle for those whose daily activities must be limited and instructed by the [securities laws]." *Id.* at 664. Accordingly, to the extent possible, there is a "need to create a bright-line rule [of materiality] that will allow firms to plan corporate transactions" and assure that "they will not be condemned no matter which way they proceed on disclosure." *Flamm v. Eberstadt*, No. 86-1754 (7th Cir. Mar. 9, 1987), slip op. 10.¹

Without a clear rule, management will be exposed to suit regardless of the disclosure action it takes. For example, at whatever point an adverse contingency is revealed, recent purchasers of the company's stock predictably will contend that the disclosure should have been made earlier (before they bought their shares); and whenever a favorable contingency is disclosed, recent sellers can be expected to argue that it should have been announced sooner. See *Flamm*, slip op. 15. Moreover, whether management decides to disclose or not to disclose a contingency, investors who are disappointed by the eventual course of events will bring suit, arguing that management should have made a different decision. See, e.g., *Walker v. Action Industries, Inc.*, 802 F.2d 703, 710 (4th Cir. 1986), cert. denied, 107 S.Ct. 952 (1987); *Reiss v. Pan American World Airways, Inc.*, 711 F.2d

¹ See also, e.g., Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5 (1975), which discusses the disclosure of contingent liabilities. FASB-5 provides, for example, that an unasserted legal claim should be disclosed if it "is considered probable" that the claim will be asserted and there is "a reasonable possibility that the outcome will be unfavorable" (§ 10). See also §§ 36, 38 (factors to be considered in evaluating the probability that a claim will be asserted and that the outcome will be unfavorable).

11, 14 (2d Cir. 1983); *Staffin v. Greenberg*, 672 F.2d 1196, 1207 (3d Cir. 1982). Companies and their shareholders should not be subject to such an inescapable risk of litigation and potential liability.

Second, premature disclosure of contingencies and inchoate developments can interfere with legitimate business objectives and reduce investor welfare. For instance, a corporation may seek to withhold public announcement of a major new contract in order to permit completion of delicate negotiations for the necessary financing. See *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 846 (2d Cir. 1981). Likewise, disclosure of a significant mineral discovery may be delayed until the company has acquired rights to the properties. See *Texas Gulf Sulphur*, 401 F.2d at 848, 850 n.12. The materiality standard governing disclosure of contingent and inchoate information must leave ample room for management's exercise of its business judgment to undertake legitimate activities that are in the best interest of the corporation and its stockholders overall.

As another example, premature disclosure of pending or prospective lawsuits and unasserted legal claims would also be undesirable. Among other concerns, such disclosure can unnecessarily intrude upon the attorney-client and work-product privileges; risk admissions that could be held against the company in litigation; result in characterizing claims as "material" even though they might later be settled on terms that would be immaterial; and, in the case of unasserted claims, invite litigation against the company that might otherwise not be brought. See generally American Bar Association, *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (1975). Such injuries to stockholder welfare should not be needlessly inflicted by an overbroad and amorphous standard of materiality.

Third, as the courts of appeals have recognized, the premature disclosure of contingencies can be confusing

and misleading to investors. Accordingly, the lower courts generally have held that this information is not material, thereby leaving to management's informed judgment the decision whether to disclose uncertain contingencies. See *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756-757 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985); *Reiss*, 711 F.2d at 14; *Staffin*, 672 F.2d at 1205-1207; *Missouri Portland Cement Co. v. H.K. Porter Co.*, 535 F.2d 388, 398 (8th Cir. 1976); *Susquehanna Corp. v. Pan American Sulphur Corp.*, 423 F.2d 1075, 1084-1085 (5th Cir. 1970). A similar conclusion has been reached for other types of "soft" information, such as projections and evaluations. See, e.g., *Walker*, 802 F.2d at 707-710; *Kademian v. Ladish Co.*, 792 F.2d 614, 625 (7th Cir. 1986); *Radol v. Thomas*, 772 F.2d 244, 252-253 (6th Cir. 1985), cert. denied, 106 S.Ct. 3272 (1986); *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 239-242 (6th Cir. 1985), cert. denied, 106 S.Ct. 1195 (1986); cf. *Flynn v. Bass Brothers Enterprises, Inc.*, 744 F.2d 978, 985-988 (3d Cir. 1984). Thus, the disclosure requirements of the federal securities laws do not insist that massive amounts of undigested information be conveyed to public investors.

Indeed, the SEC traditionally *prohibited* companies from disclosing "soft" information such as projections and appraisals in documents filed with the Commission. See, e.g., *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1291-1294 (2d Cir. 1973); *Sunray DX Oil Co. v. Helmerich & Payne, Inc.*, 398 F.2d 447, 451 (10th Cir. 1968). This policy "stemmed from [the Commission's] deep distrust of the[] reliability [of this information]" (*Gerstle*, 478 F.2d at 1294) and its concern that such disclosures "were likely to mislead investors" (*Walker*, 802 F.2d at 707).

In the past decade the SEC has shifted its position to permit—but not to require—the disclosure of financial projections and other so-called "forward-looking" information if supported by a reasonable basis and made in good faith. See 17 C.F.R. 229.10; see also *Walker*, 802

F.2d at 707, and *Starkman*, 772 F.2d at 239-241 (tracing the evolution of the SEC's change in policy). By allowing, but not requiring, disclosure the SEC has left the disclosure decision to the informed judgment of management. See also 17 C.F.R. 229.10(b)(3)(iv) ("the responsibility for determining whether to discontinue or to resume making projections is best left to management"). Moreover, recognizing the serious danger of potential corporate liability for disclosing forward-looking information, the SEC specifically adopted a "safe harbor" immunity section that provides that disclosures covered by the rule will not be deemed fraudulent unless the plaintiff shows that the information was prepared without a reasonable basis or was revealed other than in good faith. See 17 C.F.R. 230.175. These special provisions, recently adopted by the SEC after careful and extensive consideration, attest to the substantial practical problems that attend the disclosure of information about contingent or inchoate developments.

b. These considerations are well illustrated by the issue of the materiality standard governing disclosure of preliminary merger discussions. In that context, three circuits have adopted the so-called price/structure rule, under which merger talks are not material until an agreement in principle has been reached. See *Flamm*, slip op. 8-15; *Greenfield*, 742 F.2d 751; *Reiss*, 711 F.2d 11; *Staffin*, 672 F.2d 1196; see also Note, *Rule 10b-5 and the Duty to Disclose Merger Negotiations in Corporate Statements*, 96 Yale L.J. 547 (1987).²

² The government contends in its amicus brief at the petition stage (at 9 n.11, 12 n.13) that, notwithstanding the clear and recent decision in *Reiss*, the Second Circuit does not follow the price/structure rule. In support of its contention, the government relies on decisions in "insider trading" cases. However, as those decisions themselves recognize, a different (and broader) standard of materiality applies in "insider trading" cases than in cases involving allegedly false or misleading disclosures; indeed, the very fact that insiders were trading on the basis of non-public information is a compelling indication that it was material. See *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 48 (2d Cir. 1976); *SEC v. Shapiro*, 494 F.2d

The price/structure rule serves the important policies outlined above: it provides meaningful guidance to management as to when the disclosure of merger negotiations is required; it permits the exercise of informed business judgment to decide whether to make earlier disclosure; and it guards against the risk that litigation will ensue whatever disclosure decision is made. By contrast, the alternative tests fail to serve these policies. Thus, although the government has acknowledged (U.S. Am. Br. 10 n.11) that some merger discussions may be so precursory and tentative that they are immaterial as a matter of law, it has endorsed a legal standard that does not differentiate those cases from others in which the government believes that preliminary negotiations may be material. As Judge Easterbrook recently explained, however:

If disclosure must occur at an earlier date, how much earlier? That would be fertile ground for disputation. No matter how soon the firm announced the negotiations, investors could say that it should have done so a little sooner. * * * The time at which information should be disclosed ought to be readily ascertainable.

Flamm, slip op. 15. The government's approach—to let the jury apply an ad hoc balancing test to the particular facts of each individual case—does not furnish workable answers to the difficult and recurring disclosure questions that arise in the merger area.

What is more, premature public disclosure of pending merger talks can irreparably interfere with the pursuit and successful completion of the merger. See *Flamm*, slip op. 12-15; *Greenfield*, 742 F.2d at 757; *Staffin*, 672 F.2d at 1206-1207. As the foregoing decisions explain, a rule that preliminary merger negotiations are not material will best promote the overall interest of stockholders as a group.

1301, 1306-1307 & n.3 (2d Cir. 1974); see also *Texas Gulf Sulphur*, 401 F.2d at 851.

Finally, in some instances management properly could decide not to disclose preliminary merger discussions because such disclosure might be misleading to investors. See *Greenfield*, 742 F.2d at 756, 757; *Staffin*, 672 F.2d at 1205-1207. The court in *Reiss* emphasized this concern (711 F.2d at 14):

Such negotiations are inherently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned. We are not confronted here with a failure to disclose hard facts which definitely affect a company's financial prospects. Rather, we deal with complex bargaining between two (and often more) parties which may fail as well as succeed, or may succeed on terms which vary greatly from those under consideration at the suggested time of disclosure.

See also statement of SEC Commissioner Grundfest, P-H Information Services Corporate Acquisition Ideas, *Disclosure Policy: A Commissioner's Viewpoint* 5, 7 (May 1986) (premature disclosure of preliminary merger negotiations may actually be more misleading than secrecy for investment decisions). Similarly, because a corporation may have a duty to update previous statements (see, e.g., *Greenfield*, 742 F.2d at 758), "successive, possibly cancelling, announcements might have been required * * * [a]s the situation evolved," which "would have tended to confuse and mislead, rather than enlighten, the investing public" (*id.* at 757). See *Walker*, 802 F.2d at 710.

B. Management Does Not Act With Scienter If Its Decision Whether To Disclose Information About Contingent And Inchoate Developments Is Made Conscientiously And Without Intent To Defraud Investors.

In addition to materiality, scienter is an essential element of a Rule 10b-5 cause of action. Many of the policies underlying the scienter requirement also underlie the need for a clear standard of materiality, and therefore

the scienter requirement provides additional support for the price/structure rule.

Scienter is generally defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Dirks*, 463 U.S. at 663 n.23. This "independent element of a Rule 10b-5 violation" is satisfied "only where there is 'intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.'" *Ibid.* Accordingly, scienter is lacking "unless [the defendant] acted other than in good faith." *Hochfelder*, 425 U.S. at 206. See also *Dirks*, 463 U.S. at 674 nn. 10, 11 (Blackmun, J., dissenting) (scienter requires that the defendant "must know that his conduct violates or intend that it violate his duty"; "the scienter requirement functions in part to protect good-faith errors," and thus a person who "in good faith does not believe that the information is material * * * lacks the necessary scienter").

As discussed above, there are legitimate business reasons to preserve the confidentiality of preliminary merger discussions prior to agreement on price and structure. Therefore, if a corporate official, who is not trading in corporate stock, decides to withhold information about pending merger discussions in order to preserve their confidentiality for the benefit of shareholders, he is acting in good faith and without scienter.

In addition, where the materiality of information about contingent and inchoate matters is not amenable to a clearly defined test like the price/structure rule, the scienter requirement provides vital protection against unjustified damages liability. Where management conscientiously decides whether, when, and how to disclose such information in the best interests of shareholders overall, it has not acted with scienter even though the disclosure may prove to be incomplete or inaccurate. A "person making a soft disclosure in good faith and with reasonable prudence should be protected against liability,

even if his opinion or prediction turns out to be incorrect." *Schneider, Nits, Grits, and Soft Information in SEC Filings*, 121 U. Pa. L. Rev. 254, 304 (1972).

It therefore is not enough for a plaintiff to allege and prove that management knew that it was disclosing or omitting the information in question; management invariably will be aware of what it is doing. "To prove *scienter*, more than a conscious failure to disclose must be shown. Rather, there must be proof that the non-disclosure was intended to mislead." *Reiss*, 711 F.2d at 14. This standard is required by "the business judgment rule and the teachings of *Ernst & Ernst v. Hochfelder*," see *State Teachers Retirement Board v. Fluor Corp.*, 500 F. Supp. 278, 293 (S.D.N.Y. 1980), *aff'd* in pertinent part, 654 F.2d 843 (2d Cir. 1981):

[I]t is inappropriate * * * [to] focus[] the inquiry on the defendant's knowledge of the danger of non-disclosure rather than on whether it pursued the course of non-disclosure with a wrongful purpose. For instance, it is a reality of the marketplace that when management chooses to delay the release of information because it does not know if it has all the facts, or for whatever reason, rumors may circulate, and some speculators may profit from them while some shareholders, ignorant of the rumors, will sell. Under the definitions of reckless conduct which plaintiff asks this court to apply, knowledge of this danger alone, regardless of the reason for non-disclosure, would result in liability.

In other words, "there must be more than an intent not to disclose this information; there must also be proof that the omissions were made with an intent to deceive or defraud investors" (500 F. Supp. at 299). Conduct that is "mistaken but honest in belief" is not a Rule 10b-5 violation. *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 792 (7th Cir. 1977). See also, *e.g.*, *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496-497 (7th Cir. 1986); *McLean v. Alexander*, 599 F.2d 1190,

1198, 1202 (3d Cir. 1979); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044-1045 & n.20 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 200-201 (Winter 1986).

Accordingly, where management decides not to disclose information because of a concern that investors might be misled, the requisite *scienter* is lacking. See *Reiss*, 711 F.2d at 14. Similarly, if management acts for a legitimate business reason—for example, to preserve the confidentiality of pending merger negotiations (*ibid.*) or to permit sensitive financing arrangements to be made (*Fluor Corp.*, 654 F.2d at 850, 853)—it has not acted with *scienter*. In addition, as former SEC Commissioner Longstreth has explained, *scienter* cannot be shown when management's disclosure decisions were reasonably based on advice of counsel. See Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 Bus. Law. 1185, 1196 (1982). And *scienter* generally will be absent if management did not stand to benefit personally from its disclosure decisions at the expense of the company's shareholders. See *Barker*, 797 F.2d at 497; *Fluor Corp.*, 500 F. Supp. at 292.

In this case, the district court, acting on a "voluminous" and "detailed" record (Pet. App. 2a), concluded that there was no evidence of *scienter* on petitioners' part. The company's statements regarding merger discussions prior to an agreement on price and structure served legitimate business concerns. The Sixth Circuit therefore erred when it reversed the district court on the ground (Pet. App. 16a) that summary judgment is presumptively inappropriate on the issue of *scienter*. See *Anderson v. Liberty Lobby, Inc.*, 106 S.Ct. 2505, 2514 (1986).

In cases involving *scienter*, as in all other cases, a plaintiff must, in order to defeat summary judgment, adduce evidence that would be sufficient to support a

favorable jury verdict at trial. *Anderson*, 106 S.Ct. at 2510-2512, 2514. Where a plaintiff's pretrial submission fails to satisfy that standard, the case can and should be disposed of summarily. See *Celotex Corp. v. Catrett*, 106 S.Ct. 2548 (1986). Summary judgment is especially appropriate where the plaintiff's claim does not rest on an objectively reasonable premise—for example, where the action alleged to be fraudulent was not in the economic self-interest of the defendant. See *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 106 S.Ct. 1348, 1356, 1361 (1986).

These principles make clear that summary judgment properly can be entered for a defendant on the issue of scienter, as a number of courts have held in Rule 10b-5 cases. See, e.g., *Barker*, 797 F.2d at 496; *Bryson v. Royal Business Group*, 763 F.2d 491 (1st Cir. 1985); *Reiss*, 711 F.2d at 13-14; *Fluor Corp.*, 500 F. Supp. at 294, 299. The Sixth Circuit suggested no reason why the same disposition was not appropriate here.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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AMICUS CURIAE

BRIEF

APR 30 1987

JOSEPH F. SPANIOLO, JR.
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IN THE
Supreme Court of the United States
 OCTOBER TERM, 1986

BASIC INCORPORATED, ET AL.,
 —v.—

Petitioners,

MAX L. LEVINSON, ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT
 OF APPEALS FOR THE SIXTH CIRCUIT

**BRIEF AMICI CURIAE OF ARTHUR ANDERSEN & CO.,
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 DELOITTE, HASKINS & SELLS, ERNST & WHINNEY,
 PEAT MARWICK MAIN & CO., PRICE WATERHOUSE,
 AND TOUCHE ROSS & COMPANY
 IN SUPPORT OF PETITIONERS**

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April 30, 1987

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IN THE
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—v.—

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**BRIEF AMICI CURIAE OF ARTHUR ANDERSEN & CO.,
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 AND TOUCHE ROSS & COMPANY IN SUPPORT OF
 PETITIONERS**

INTEREST OF THE AMICI CURIAE

With the consent of the parties pursuant to Rule 36 of the Rules of the Court, the amici curiae submit this brief in support of petitioners with respect to the second question presented.

The amici curiae are firms engaged in the practice of the profession of accounting and auditing. They believe they are the largest of such firms practicing in the United States, reporting, collectively, on the financial statements of more than 90 percent of those companies whose securities are publicly traded.

Auditors, more than any others, will be hurt by the class certification branch of the Sixth Circuit's decision. For example, three of the amici petitioned the Court, following earlier circuit court decisions in which they were defendants, raising the issue presented by the second question here. See *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *cert. granted sub nom. Price Waterhouse v. Panzirer*, 458 U.S. 1105, *vacated as moot*, 459 U.S. 1027 (1982); and *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

Unlike their respective corporate clients, each of whom issues financial and other statements to the public a limited number of times per year, auditors issue reports as many times a year as they have publicly-held clients. For the larger accounting firms, that means several thousand times a year. Thus, by permitting class certification in the absence of reliance because of an allegedly false public utterance, the Sixth Circuit has exposed the accounting profession to the very nightmare prophesied by then Chief Judge Cardozo in *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179 (1931), quoted in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 215 n.33 (1976), and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748 (1975): "liability in an indeterminate amount for an indeterminate time to be an indeterminate class."

SUMMARY OF ARGUMENT

The efficient capital market hypothesis may or may not be accepted economic doctrine. What is beyond dispute is its lack of acceptance—indeed, recognition—in 1934, when Congress enacted a comprehensive statutory scheme explicitly requiring actual reliance, the causal connection between injury and wrongdoing.

Prior to its adoption of that scheme, the Securities Exchange Act of 1934, Congress considered a cause of action for investor injury where the price of a security may have been affected by

a misleading statement. It expressly rejected mere price effect and substituted a requirement that the investor rely on the statement.

Ignoring congressional intent, the authorities invoked by the court below closely follow *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), where "fraud on the market" as an extension of the efficient capital market theory was first judicially expounded. Fraud on the market has since been seized upon as a veritable cure-all for the difficulties encountered in many nationwide class actions, so as to alter fundamentally the elements of a 10b-5 cause of action. An accommodation based on economic theory to facilitate application of Rule 23 has thus greatly modified substantive rights, despite 28 U.S.C. § 2072 (1982) ("[s]uch rules shall not abridge, enlarge or modify any substantive right").

ARGUMENT

SECTION 10(b) OF THE 1934 ACT AND RULE 10b-5 DO NOT CONTAIN AN EXCEPTION FOR FRAUD ON THE MARKET

That misstatements affect the integrity of an efficient market is problematic. The Court need not concern itself, however, with economic theory to resolve the second question presented.¹

¹ "Of all recent developments in financial economics, the efficient capital market hypothesis ("ECMH") has achieved the widest acceptance by the legal culture. . . . Yet the legal culture's remarkably rapid and broad acceptance of an economic concept that did not exist twenty years ago is not matched by an equivalent degree of understanding." See Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549-50 (1984) (footnotes omitted). For example, one

Statutory Language

Actions sounding in tort require that there be a reasonably direct and close causal connection—proximate cause—between the defendant's wrongdoing and the plaintiff's injury. In an action for deceit the injury lies in the plaintiff's response to the defendant's deception and there must be a causal connection between the two.²

Section 10(b) forbids the use of any manipulative device or contrivance "in connection with the purchase or sale of any security." 15 U.S.C. § 78j(b) (1982). The three subdivisions of Rule 10b-5, 17 C.F.R. § 240.10b-5 (1986), which implement section 10(b) are, of course, also subject to the limitation that the proscribed conduct be "in connection with the purchase or sale of any security."

The "in connection with" limitation or requirement was the basis for the holding of *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), that section 10(b) and Rule 10b-5 apply only to an actual purchase or sale induced by the defendant's wrongdoing, not to a decision to refrain from buying or selling although that decision was, like the decision to buy or sell, induced by a violation of section 10(b) on the part of the defendant. *Blue Chip Stamps* placed one limitation upon the conceivable universe of potential section 10(b) suit-

court concluded that an efficient market will exactly match price with value, a proposition that would surprise security analysts and investment advisors. See *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (N.D. Tex. 1980), quoted with approval in Note, *The Fraud-On-The-Market Theory*, 95 Harv. L. Rev. 1143, 1155 (1982). From the efficient market hypothesis, the legal extrapolation moved to market integrity based on the reliance of other traders—i.e., other than the oblivious investor—upon public information. That, in turn, led to distortion of integrity caused by fraud on the market. *Id.* at 1153-56. The latter theory, in addition to the underlying efficiency and integrity assumptions, requires that the market react to a public utterance in the same fashion as would an individual investor who had read or heard it.

² See, e.g., W. Prosser & W. Keeton, *The Law of Torts* §§ 105-108 (5th ed. 1984).

ors. Another limitation, also derived from the required "in connection with" nexus between the plaintiff's decision to buy or sell and the defendant's violation, is at issue here.³

Reliance provides the necessary causal connection. As stated by the Court of Appeals for the Second Circuit: "The element of reliance serves to restrict the potentially limitless thrust of Rule 10b-5 to those situations in which there exists causation in fact between the defendant's act and the plaintiff's injury." *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92 (2d Cir. 1981) (citations and footnote omitted). See also *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516 (10th Cir. 1983); *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978); *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976) (*en banc*), *cert. denied*, 430 U.S. 955 (1977); *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

In *Blue Chip Stamps*, *supra*, the Court feared that broadening the class of 10b-5 plaintiffs would do "more harm than good" because it could expose defendants to "liability in an indeterminate amount for an indeterminate time to an indeterminate class." 421 U.S. at 747-48. Accord *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214-16 n.33 (1976).

All twenty-two judges participating in the 12 to 10 *en banc* decision in *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983), agreed that Rule 10b-5 should not be interpreted to "establish a scheme of investors' insurance" (647 F.2d at 469 n.5) (majority); "the securities laws enacted by Congress in the 1930s were not intended to create a scheme of investors' insurance" (647 F.2d at 482) (dissent). See also *Dirks v. SEC*, 463 U.S. 646, 667 n.27 (1983) ("as market values fluctuate and investors act on inevitably incomplete or incorrect information, there always are winners and losers; but those who have 'lost' have not necessarily been defrauded");

³ It is noteworthy that in *Blue Chip Stamps*, the Court presumed that the plaintiff read the prospectus and paid some attention to it. See 421 U.S. at 746.

List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965). The decision here, however, established just such a scheme of investor insurance.

The court of appeals' decision, if approved, would have the following result in a class action: Every investor who purchased or sold in a class period would be able to recover against any person whose misstatement arguably had an impact upon price without any consideration of whether that particular investor paid any attention to the particular misstatement complained of, provided only that he was able to prove the existence of the misstatement. That is a basic change in Rule 10b-5 actions, which, except for the other circuit court decisions discussed *infra*, heretofore required the existence of some causal connection between the misstatement and the purchase decision. Inexorably, approval of the court of appeals' decision will result in the commencement of more securities suits and a significant increase in exposure in the suits that are brought.

The court of appeals disguised the insurance scheme it was adopting by stating that reliance was only a presumption that could be rebutted in specified ways. Examination of the rebuttal alternatives, however, proves them meaningless. The first—that the defendant can prove his misstatement did not have a material impact upon price because an insufficient number of traders relied on it—does nothing more than restate the requirement of materiality, an element of *plaintiff's* prima facie case. Of course a defendant is not liable for an immaterial misstatement; casting this concept in terms of a rebuttal gives no substance to it as a meaningful limitation upon the presumption.

The second alternative—that the defendant may prove the plaintiff knew of the misstatement or would have bought anyway—is illusory. In the context of a large-scale developed market, it will be nigh impossible to identify the plaintiff who will admit to knowing of the alleged misstatement. Considerable time and energy would be spent to ferret out those who simply do not care. While it is conceivable that the rebuttal

might become a factor in a rare circumstance, it does not change the basic nature of the insurance scheme adopted by the court of appeals. As a practical matter, the presumption is conclusive.

The burden of an investor insurance scheme weighs particularly hard upon auditors. They are the most peripheral to the alleged scheme and earn only a fee based on time expended for professional services, yet bear the biggest monetary risk because of their "deep-pocket" status—a risk intensified by the growing willingness of companies to file in bankruptcy and thus avoid their own legal liabilities. For those reasons, as well as the sheer breadth of their practice, these peripheral defendants are sued whenever one of their clients experiences economic difficulties. Their exposure is a multiple of the number of lawsuits brought against them and it is no secret that professional insurance has become both more difficult and more expensive to obtain. The decision below threatens to increase both the number of suits and the individual exposure on each one. It is hardly unreasonable to ask instead that the plaintiffs in such lawsuits at least allege (and later prove) that they relied in some manner on the work done by such defendants.

Legislative History

The legislative history of section 18 of the 1934 Act, 15 U.S.C. § 78r (1982), an express remedy for fraud violations, is relevant to the proper understanding of section 10(b), which is an implied remedy. The initial version of the provision which later became section 18 required only that the plaintiff be a person "who shall have purchased or sold a security *the price of which may have been affected by such statement.*" S. 2693, 73d Cong., 2d Sess. § 17(a) (1934) (emphasis supplied). (There is, of course, no difference between a price "affected by" a misleading statement and a price artificially inflated, or deflated, by a misleading statement.) That version was criticized in the hearings concerning the 1934 Act because it permitted recovery of damages by persons "who ha[d] not relied upon

the inaccurate or misleading statement" and by those who "trade recklessly" and by "unscrupulous traders" who were not misled by the statements later alleged to be false.⁴

Because of that criticism, the bill was redrafted and the requirement of purchase or sale "in reliance upon such statement" was added. As explained by Representative Sam Rayburn, then Chairman of the Committee on Interstate and Foreign Commerce:

"The first provision of the bill as originally written was very much challenged on the ground that reliance should be required. This objection has been met." (78 Cong. Rec. 7701 (April 30, 1934))

See also S. Rep. No. 792, 73d Cong. 2d Sess. 13 (1934) ("the burden is on the plaintiff to show . . . that he relied [on the misleading statement] to his damage"), quoted in *Ernst & Ernst v. Hochfelder*, *supra*, 425 U.S. at 206.

The "fraud on the market" theory conflicts with this legislative history; in adopting it, the court of appeals ignored the Court's admonition in *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979), that "[t]he ultimate question is one of congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Congress enacted into law."

The theory also places directly in issue a point several times raised but never decided by the Court—whether it is permissible to infer a private right of action (section 10(b)) which effectively nullifies an express remedy contained within the same statute (section 18). See *Ernst & Ernst v. Hochfelder*, *supra*, 425 U.S. at 210; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383-84 (1983).

⁴ *Stock Exchange Practices: Hearings on S. Res. 84, S. Res. 36 and S. Res. 97 Before Sen. Comm. on Banking and Currency, 73d Cong., 2d Sess. 6638, 7084 (1934) ("1934 Senate Hearings"); Stock Exchange Regulation: Hearing on H.R. 7852 and 8720 Before House Comm. on Interstate and Foreign Commerce, 73d Cong. 2d Sess. at 226, 656 (1934) ("1934 House Hearings"). See also 1934 Senate Hearings at 6939, 7186, 7567-68; 1934 House Hearings at 262, 489.*

In *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), the Court stated with respect to a 10b-5 action:

"[T]he 'fundamental purpose' of the [1934] Act [is] implementing a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." (430 U.S. at 477-78) citing *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970))

In holding that plaintiffs who admittedly were unaware of the allegedly misleading statements nonetheless stated a cause of action, the court of appeals rendered inconsequential the method employed by Congress to implement the "fundamental purpose" of full disclosure. See *Shores v. Sklar*, *supra*, 647 F.2d at 483 (Randall, J., dissenting):

"[F]ederal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make If we say that a plaintiff may recover in some circumstances even though he did not read and rely on the defendants' public disclosures, then no one need pay attention to those disclosures and the method employed by Congress to achieve the objective of the 1934 Act is defeated."

Decisions Of Other Circuits

Of the authorities relied on below, three warrant discussion, *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985), *Ross v. A.H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980), and *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).⁵

⁵ By contrast, the reliance on *Shores v. Sklar*, *supra*, was misplaced. There the very "genuineness" of the security was in question (647 F.2d at 469-70). It was in the context of that situation that *Blackie v. Barrack* was cited with approval (*id.* at 471). The holding of *Shores* is

In *Blackie*, the court's opinion depended on its view that it might properly define and structure the elements of a section 10(b) action as it thought best in order to permit class action treatment. It said that if the class action were subverted by "delaying and harassing tactics . . . , we may have to reconsider whether to make proof of causation from materiality conclusive, keeping in mind that the Court has directed that the statute be liberally construed to effectuate its remedial purposes, and that that purpose may be served only by allowing an overinclusive recovery to a defrauded class if the unavailability of the class action device renders the alternative a grossly underinclusive recovery" (524 F.2d at 907 n.22). The court rejected the defendants' argument that their rights were being abridged in violation of the Rules Enabling Act, 28 U.S.C. § 2072. It said: "Indeed, we could, in the exercise of our Article III jurisdiction, transform the 10b-5 suit from its present private compensatory mold by predicated liability to purchasers solely on the materiality of a misrepresentation (i.e., economic damage) regardless of transactional causation, without implicating the Enabling Act limitation" (524 F.2d at 908 n.24). Subject only to the theoretical possibility of rebutting the presumption it had created, however, that is precisely what the court said it was doing so as to avoid an argument against class action treatment.⁶

The court of appeals in *Blackie* asserted a claim to the authority of common law courts without regard to the constitutional separation of powers which entrust the law-making

more to the point: "If [the plaintiff] proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed, he cannot recover" (*id.* at 470). "Reliance is an essential element of [the usual 10b-5 case]" (*id.* at 468). The limited reach of *Shores* was recognized by the ten dissenting judges (*id.* at 472-73) and by the courts that have analyzed it. See, e.g., *Kennedy v. Nicastro*, 517 F. Supp. 1157, 1159 (N.D. Ill. 1981). But cf. *Lipton v. Documentation, Inc.*, *supra*, 734 F.2d at 743-47.

⁶ See Note, *The Reliance Requirement In Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 596-97 n.65 (1975).

power to Congress. It did so, of course, before the numerous decisions of the Court in recent years which stress the fundamental significance of congressional intent, not remedial purposes and methods perceived by the courts, e.g., *Touche Ross & Co. v. Redington*, *supra*. And the *Blackie* opinion ignored the legislative history of the 1934 Act.

Ross involved the question that was posed in *Ernst & Ernst v. Hochfelder*, *supra*, and remains unanswered: "whether a cause of action may be maintained under § 10(b) on the basis of action that would constitute a violation of § 18" (425 U.S. at 211 n.31). The court answered the question in the affirmative. It distinguished section 10(b) from section 18 in several respects including, so it said, a presumption of reliance if "the material misrepresentation affected the price of stock traded on the open market" (607 F.2d at 553), citing *Blackie*. Since the plaintiffs in *Ross* had expressly disclaimed any reliance on the documents in issue, the presumption relied upon by the court in upholding their complaint was in fact made conclusive. A conclusive presumption is "a process of concealing by fiction a change in the substantive law." F. James & G. Hazard, *Civil Procedure* § 7.9, 253 (2d ed. 1977).

The presumption stated in *Blackie* and *Ross* as an attribute of section 10(b) actions was not, however, mentioned by the Court in *Herman & MacLean v. Huddleston*, *supra*, 459 U.S. at 382-90, where the attributes of the action were described. There the Court held that the availability of an express remedy under section 11 of the 1933 Act, 15 U.S.C. § 77k (1982), did not preclude the maintenance of a section 10(b) claim. The Court pointed to the "added burden of proving scienter" in section 10(b) actions (459 U.S. at 384). The Court did not suggest that reliance—a causal connection between the investment decision and the statutory violation—is not a necessary element of a section 10(b) claim based upon a misleading statement.

Lipton is the most recent of the circuit court decisions invoked below. Apart from its detailed albeit debatable reading of *Shores v. Sklar*, *supra*, the Fifth Circuit merely restated the *Blackie* rationale.

CONCLUSION

Since approximately one-third of all cases, public and private, brought under the federal securities statutes are 10b-5 actions, see 1 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud* § 2.5(6) (1986), and of the latter, we believe, an even higher percentage are class actions, it is imperative that the Court reemphasize the causation/reliance element of the judicially created 10b-5 remedy. See *Blue Chip Stamps v. Manor Drug Stores*, *supra*, 421 U.S. at 737.

The potential breadth of the rule announced by the court of appeals cannot be overestimated. Statements that include information, rumor, advice, opinion and crystal ball gazing about publicly-traded companies are extremely widespread. They appear as news stories in the daily press; as articles ranging from topical events to "think pieces" in weekly publications of general orientation (e.g., *Time*, *Newsweek*) and business orientation (e.g., *Business Week*, *Barron's*); as specialized, paid-subscription services (e.g., *Value Line Survey*); as investment letters or reports on in-house research by brokerage houses and investment advisors; and as tips, rumors and speculation circulating within the investment community. They are heard regularly on radio and television (e.g., *Wall Street Week*).

Any such statement, opinion, rumor or tip can induce investment decisions. Many are expressly designed to do so. Under the holding below, the business and financial communities, and the accounting profession, are faced with extensive discovery, trial and possible civil liability arising from every investment decision if the plaintiff merely alleges that his investment was preceded—and thus by hypothesis was influenced in some way—by misleading reports that the plaintiff has never seen or heard. The decision below would permit a

10b-5 action to be maintained upon the mere coincidence in time between the allegedly misleading statements and market gossip that persuades an investor to purchase.

The question of whether federal legislation should provide a compensation scheme for those who do not rely on the statement which they later claim to be misleading was addressed and answered in the negative when section 10(b) was enacted. A change in that answer, under the Constitution, can only be made by Congress.

The judgment of the court of appeals affirming class certification should be reversed.

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AMICUS CURIAE

BRIEF

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JOSEPH F. SPANGL, JR.
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IN THE
Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust, and
RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

**BRIEF OF AMERICAN INSTITUTE OF CERTIFIED
PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*
IN SUPPORT OF PETITIONERS**

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This *Amicus Curiae* brief addresses the second question upon which this Court granted certiorari, which may be restated as follows:

Should recovery under Rule 10b-5 be extended to a class of all persons who sold shares of a company's stock during a fourteen-month period when the company issued allegedly false and misleading statements, by applying a blanket presumption of reliance as a substitute for the requirement that each class member show actual reliance on the statements?

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-279

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS, JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER, H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C. WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as trustee under the Karl Zuckerman Revocable Trust, and RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

**BRIEF OF AMERICAN INSTITUTE OF CERTIFIED
PUBLIC ACCOUNTANTS AS AMICUS CURIAE
IN SUPPORT OF PETITIONERS**

PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae* pursuant to Rule 36.2 of the Rules of this Court in support of petitioners,¹ and urges this Court to reverse the judgment of the United States Court of Appeals for the Sixth Circuit entered in these proceedings on March 27, 1986, reported at 786 F.2d 741 (6th Cir. 1986), insofar as it affirmed the Memorandum and Order

¹ This brief is submitted on consent of the parties. The written consents of Petitioners and Respondents are being filed with the Clerk of the Court contemporaneously herewith.

of the United States District Court for the Northern District of Ohio, entered on December 10, 1981, granting respondents' motion for class action certification pursuant to Rule 23(b)(3) of the Federal Rules of Civil Procedure. Appendix to the Petition for a Writ of Certiorari ("J.A.") at 113a-127a.

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*

The Institute is a national accounting organization, all of whose approximately 250,000 members are certified public accountants. Among the Institute's purposes are the promotion and maintenance of high professional standards of practice. In the pursuit of those ends, the Institute has come to be accepted as the authoritative source of standards and procedures in its field.

As the issuer of these standards, the Institute has a profound interest in the scope and bases of civil liability sought to be imposed on auditors in connection with their performance of professional engagements under the rubric of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982) ("Section 10(b)" and the "1934 Act") and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1986) ("Rule 10b-5") promulgated thereunder. The Institute's substantial and legitimate interest in this body of law has long been recognized both by this Court and Congress.²

Although this case does not involve a claim against a member of the accounting profession, the potential impact of the Sixth Circuit's ruling on that profession is severe. Accountants play an integral role in the dissemination of financial

information, a process which rests at the core of the federal securities laws. That role inevitably exposes accountants to claims by individuals and aggregated classes based on the "fraud on the market" theory adopted below. Under that theory, purchasers or sellers of securities who have never read, much less relied on, any financial statement audited by an accountant, or even any document that reported on or referred to such an audited financial statement, can sustain an action under Section 10(b) and Rule 10b-5 promulgated thereunder against the accountant who audited that financial statement. Because Rule 10b-5 claims are frequently raised, as in the instant case, in class actions, the costs of such litigation and the risk of adverse judgments are multiplied.

STATEMENT

Petitioners, Basic Incorporated ("Basic") and officers and directors of Basic, entered into a merger agreement with Combustion Engineering, Incorporated ("C-E") in December 1978. Respondents, all of the Basic shareholders who sold Basic stock during a fourteen-month period preceding the merger, alleged that "no corporate developments" statements issued by Basic during this period were false and misleading because such statements failed to disclose that, throughout this period, Basic and C-E were engaged in merger negotiations. Respondents contend that those statements artificially depressed the price of Basic stock and that the putative class members were damaged when they sold Basic shares for less than their purported true value.

In their motion for class certification, respondents argued that they were entitled to a presumption of reliance on the integrity of the stock market and that individual members did not have to demonstrate that they actually relied on any of Basic's allegedly misleading statements. The District Court agreed and certified the class, noting that, absent this presumption of reliance, individual issues of reliance would have predominated and barred class certification. J.A. at 118a.

² The Institute was invited to and did submit a position paper to the United States Senate concerning the proposed scope of civil liabilities and damages under the 1934 Act. *Hearings on S. Res. 84 (72d Cong.), S. Res. 56, and S. Res. 97 Before the Comm. on Banking and Currency, 73d Cong., 1st Sess., pt. 15, at 7207-10 (1934)*. Furthermore, this Court has permitted the Institute to file briefs *amici curiae* on related issues in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); *Aaron v. SEC*, 446 U.S. 680 (1980); and *Ross v. A. H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980).

The Court of Appeals affirmed the class certification order. The court held that a seller of stock has a private right of action under Section 10(b) and Rule 10b-5 promulgated thereunder on the basis of an issuer's allegedly materially misleading public statements, notwithstanding that the seller of stock did not rely on such statements and, indeed, may never have read or learned of such statements. The court reached this conclusion by reasoning that a material misrepresentation inevitably distorts the price of the stock on the impersonal market—the so-called “fraud on the market” theory. On this basis, all sellers of the stock during the period from the misstatement until the time the truth was revealed, regardless of whether they had knowledge of the misrepresentation, were presumed to have relied on it, and were entitled to seek monetary damages.

SUMMARY OF ARGUMENT

Definition of the contours of the private cause of action implied under Section 10(b) and Rule 10b-5 requires analysis of the language of the statute and its related sections, and of the legislative history. Without undertaking such an analysis, the court below ruled that a person who bought or sold securities in a developed market after a material misrepresentation was made could be presumed to have relied on the misrepresentation in doing so: *post hoc ergo propter hoc*. Since Aristotle, that proposition has been rejected as bad logic; it is also bad law and bad public policy.

As this Court has long recognized, the full text of the securities laws and their legislative history establish that Congress intended to require that a plaintiff demonstrate actual reliance in order to recover damages under Section 10(b). Neither the opinion below nor the decisions of any other lower courts suggest any sound basis for abandoning that fundamental principle in order to adopt the proffered fraud on the market theory.

Indeed, the experience of the federal district and circuit courts that have attempted to apply the fraud on the market theory provides persuasive evidence that the theory is inherently unsound and unmanageable. Despite this Court's effort in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) to delineate the narrow factual circumstances in which it may be appropriate to presume reliance, lower courts have applied that presumption in very different factual contexts, using divergent and sometimes inconsistent legal standards. The result has been to increase uncertainty and risk for parties who participate in the financial markets.

Adoption of the fraud on the market theory in misrepresentation cases would be both unnecessary and unwise. It is unnecessary because the supposed problem of proof for plaintiffs is illusory. Unlike the case of a nondisclosure such as was involved in *Affiliated Ute*, in which it is difficult for a plaintiff to present evidence of reliance, one who alleges he was victimized by a misrepresentation need only show he knew of the misleading statement and acted on it. Adoption of the fraud on the market theory is unwise because it is premised on a fiction. It is simply not the case that a single misleading statement, even if material, will inevitably have a substantial impact on the entire market's valuation of a given security. The modern financial markets are infinitely more complex than this theory assumes.

The fraud on the market theory does nothing to increase the protection of investors who actually rely on false information, but provides a windfall to others whose losses in the market are wholly unrelated to any public disclosures by companies or their accountants. The theory will contribute to the proliferation of class actions in which accountants and others are often pressured to settle by the sheer magnitude of litigation costs, regardless of the merits of the claims against them, by enabling plaintiffs to circumvent the Rule 23(b)(3) predominance requirement. Furthermore, the very nature of class actions all too often means that the presumption of reliance is *de facto* irrebuttable because the cost of trying to establish each individual plaintiff's lack of reliance, even if such proof were possible, is prohibitive.

The Court of Appeals brushed aside these concerns in arriving at the result reached below. But the now substantial body of experience illustrating that the rule is a source of confusion and coercion in its application, coupled with the rule's demonstrable inconsistency with the statutory source from which it is supposed to spring, makes it important now to reject decisively the fraud on the market theory in federal securities cases. The decision of the Court of Appeals should accordingly be reversed.

ARGUMENT

I.

THE RULE OF LAW ADOPTED BY THE COURT BELOW IS CONTRARY TO CONGRESSIONAL INTENT AS ESTABLISHED THROUGH APPLICATION OF GOVERNING PRECEDENTS OF THIS COURT.

This Court is now called upon to shape still another contour of the private cause of action for damages implied under Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. The process of defining the permissible scope of this implied remedy was begun in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), and continued apace in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); *Aaron v. SEC*, 446 U.S. 680 (1980); and *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). Here the issue focuses on the nature of the proof of reliance required in a Rule 10b-5 case involving allegedly misleading public statements. Specifically, the question is whether the requisite reliance may be demonstrated, not by reliance on the public statements themselves, but by presuming that all sellers of the company's stock, regardless of their awareness of the company's alleged misstatements, relied on

the "integrity of the market" during the open-ended period from the time those statements were made until the time the supposed truth is discovered.

Allowing a private right of action in damages under Section 10(b) on the basis of such an attenuated causal nexus finds no warrant in either the language of that section or the provisions of the 1934 Act as a whole. The statute itself indicates that civil liability in damages with respect to documents filed with the SEC should not be created in favor of anyone who bought or sold a security without having relied upon those documents. The 1934 Act as a whole represents a deliberately drawn legislative balance apportioning enforcement among administrative regulation, self-enforcement and liability to third parties. The legislative history persuasively confirms that Congress did not intend the statutory construction advanced by the court below. Indeed, an examination of the statute and the discussions underlying its enactment shows that Congress, as part of its regulatory scheme, carefully circumscribed private rights of action in a fashion precluding the claims asserted here.

A. Established Principles Of Statutory Construction Preclude The Imputation Of A Cause Of Action Inconsistent With The Statutory Text And Scheme.

As this Court has often reiterated, "The question of the existence of a statutory cause of action is, of course, one of statutory construction." *Touche Ross & Co. v. Redington*, 442 U.S. at 568 (citing *Cannon v. University of Chicago*, 441 U.S. 677, 688 (1979) and *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. 453 (1974)). The same is true of the scope and elements of such a cause of action. As the Court has held, "[G]eneralized references to the 'remedial purposes' [of the 1934 Act] will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.'" *Aaron v. SEC*, 446 U.S. at 695 (quoting *Touche Ross & Co. v. Redington*, 442 U.S. at 576 (quoting *SEC v. Sloan*, 436 U.S. 103, 116 (1978))). As noted in *Cannon*, "[T]he fact that a federal statute has been violated and some

person harmed does not automatically give rise to a private cause of action in favor of that person." 441 U.S. at 688.³

Rather, faced with repeated attempts to imply private remedies in damages under the securities laws, this Court has consistently defined the appropriate analysis as "limited solely to determining whether Congress intended to create the private right of action And as with any case involving the interpretation of a statute, our analysis must begin with the language of the statute itself." *Touche Ross & Co. v. Redington*, 442 U.S. at 568 (citations omitted). *Accord Cannon v. University of Chicago*, 441 U.S. at 689; *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979); *Santa Fe Indus. v. Green*, 430 U.S. at 472; *Piper v. Chris-Craft Indus.*, 430 U.S. at 1; and *Ernst & Ernst v. Hochfelder*, 425 U.S. at 197, 200-01.

At the same time, however, this textual emphasis does not concentrate upon the words of a particular provision alone—admittedly powerful in and of themselves, see *Santa Fe Indus. v. Green*, 430 U.S. at 477, and *United States v. Oregon*, 366 U.S. 643, 648 (1961)—but also gains definition from the statute taken as a whole. See *Touche Ross & Co. v. Redington*, 442 U.S. at 571; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 736. As this Court stated in both *Blue Chip Stamps* and *Hochfelder*, "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen" *Ernst & Ernst v. Hochfelder*, 425 U.S. at 206 (quoting *SEC v. National Sec., Inc.*, 393 U.S. 453, 466 (1969)). See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 727-30.

In particular, this court has recognized that "where a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it." *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 19 (1979). *Accord*

³ Notably, *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976), the first court of appeals decision to apply a presumption of reliance under Section 10(b) and Rule 10b-5, was decided before this line of Supreme Court cases and limited its analysis of "statutory construction" to the now discredited incantation of the remedial purposes of those provisions. *Id.* at 907.

University Research Ass'n v. Coutu, 450 U.S. 754, 773 n.24 (1981); *Kissinger v. Reporters Comm. For Freedom of the Press*, 445 U.S. 136, 148-49 (1980); *National R.R. Passenger Corp. v. National Ass'n of R.R. Passengers*, 414 U.S. at 458. This injunction is particularly apt where, as here, the cause of action sought to be implied is broader than the explicit cause of action provided in terms by the Act. As is noted in *Blue Chip Stamps*:

It would be indeed anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action.

421 U.S. at 736.⁴ Without even a passing reference to the text of the 1934 Act or to congressional intent, the court below adopted a rule of law creating just such an anomaly.

B. The Language and Structure Of The Statute Reflect A Congressional Intent To Circumscribe Narrowly Civil Liability In Damages Based On A Showing Of Reliance Far Stronger Than That Accepted By The Court Below.

Section 10(b) of the 1934 Act makes it "unlawful for any person . . . to use or employ . . . any manipulative or deceptive device or contrivance in contravention of [SEC] rules" Rule 10b-5 prohibits, in addition to nondisclosure or misrepresentation, any "artifice to defraud" or any act "which operates or would operate as a fraud or deceit" Thus,

⁴ This Court's decision in *Herman & MacLean v. Huddleston*, 459 U.S. 375, is not to the contrary. *Huddleston* held that the availability of an express remedy under § 11 of the 1933 Act did not preclude an implied cause of action under Rule 10b-5. However, in reaching its decision, the Court relied on the fact that, because of the scienter requirement, "a § 10(b) plaintiff carries a heavier burden than a § 11 plaintiff." 459 U.S. at 382. Here, on the other hand, by circumventing the reliance requirement, the lower court seeks to place a lighter burden on § 10(b) plaintiffs than on plaintiffs suing under the express provisions of §§ 9 and 18, and to thus expand the reach of the implied remedy of § 10(b) beyond the remedies expressly provided by Congress. Such a rule does not follow from *Huddleston*; and nothing in *Huddleston* remotely suggests that the reliance requirement in a Rule 10b-5 case should be relaxed.

the language of the statute supplies no basis for concluding that Congress intended to relax the requirement of reliance, which is traditionally regarded as an essential element of an action for fraud.⁵

Reference to the statutory provisions providing express remedies that flank Section 10(b), as well as analogous provisions in the Securities Act of 1933, 15 U.S.C. § 77(a), *et seq.* (1982) (the "1933 Act"),⁶ confirms the view that Congress intended to preserve the requirement of reliance as an element of a private action based upon violations of the securities laws. Thus, Section 18(a) of the 1934 Act, 15 U.S.C. § 78r(a) (1982) ("Section 18(a)"), creates a private cause of action against persons who "make or cause to be made" materially misleading statements in any reports or other documents filed with the SEC, but conditions the imposition of liability upon proof that the plaintiff, "*in reliance* upon such statement, shall have purchased or sold a security at a price which was affected by such statement" *Id.* (emphasis added).

Thus, recovery under Section 18(a) is expressly limited to purchasers or sellers who can satisfy what has been termed its "double-barreled" causation requirement" by demonstrating that the alleged damages were caused by reliance on the false or misleading statement and that the purchase or sale price was affected by the false or misleading statement. *Rich v. Touche Ross & Co.*, 415 F. Supp. 95, 103 (S.D.N.Y. 1976) (citations omitted); *see also Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 429 n.6 (6th Cir.), *cert. denied sub nom. Adams v. Peat, Marwick, Mitchell & Co.*, 449 U.S. 1067 (1980). Nowhere in the 1934 Act did Congress indicate any intention to expand the contours of a private damage remedy for

⁵ See *Restatement (Second) of Torts* § 525 (1977); W. Prosser, *Handbook of the Law of Torts* § 105, at 685-86 (4th ed. 1971).

⁶ This Court has repeatedly observed that the 1933 Act and 1934 Act are interrelated components of an integrated scheme of federal securities regulation and should be interpreted in concert with each other. *See Herman & MacLean v. Huddleston*, 459 U.S. at 380; *Ernst & Ernst v. Hochfelder*, 425 U.S. at 206; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 727-30.

false or misleading statements beyond that allowed by Section 18(a).

Section 11 of the 1933 Act, 15 U.S.C. § 77(k) (1982), contains analogous restrictions relating to reliance. As originally enacted, Section 11 provided a private right of action in damages to market buyers of registered securities where the registration statement contained a material untruth or omission without regard to reliance. However, in connection with the enactment of the 1934 Act, Congress further restricted the cause of action made available under Section 11 by requiring the purchaser to show reliance on the prospectus once an earnings statement covering a period of at least twelve months had been made generally available to security holders. Pub. L. No. 291, 48 Stat. 907, 73d Cong., 2d Sess. (1934). Thus, at the same time that it enacted the 1934 Act, Congress restructured Section 11 to impose a reliance requirement in the statutorily determined, publicly traded aftermarket.

In Section 9 of the 1934 Act, 15 U.S.C. § 78i (1982) ("Section 9"), Congress addressed the precise issue of false statements having market impact. Section 9(a)(4), for instance, makes it unlawful for a person "to make, regarding any security registered on a national securities exchange, for the purpose of inducing the purchase or sale of such security, any statement which [is] . . . false or misleading with respect to any material fact" In Section 9(e), Congress expressly created a private cause of action in damages for violation of Section 9(a)(4). Although Section 9(e) does not specifically refer to reliance,

[I]t contains a causation requirement which is probably stricter than the burden the plaintiff would face in a common law deceit action based on the defendant's manipulation: Not only are damages limited to those "sustained as a result" of the manipulation; the plaintiff must also show that he bought or sold "at a price which was affected by" the manipulation.

3 L. Loss *Securities Regulation* 1748 (2d ed. 1961).⁷ Further, Section 9(e) expressly limits liability to actual participants in securities transactions. Thus Congress has expressly provided a remedy in Section 9 that is far more limited in scope than the remedy that the court below implies under Section 10(b).

The rule announced by the Sixth Circuit thus extends the permissible scope of recovery pursuant to the implied remedy under Section 10(b) far beyond the confines Congress set in enacting the express remedies set forth in Sections 9 and 18(a), in contravention of the deference to that scheme announced by this Court in *Touche Ross & Co. v. Redington*, 442 U.S. at 574. The architecture of the statutory scheme, including the scope of the express remedies provided, the careful calculus of liability exposure and restrictions set out in its terms, and the contemporaneous amendments to the intimately related 1933 Act all dictate that the expansive rule adopted below should be repudiated.

C. The Legislative History Confirms That Congress Did Not Intend To Impose Civil Liability In Damages On The Basis Of The Purported Reliance Accepted By The Court Below.

The legislative history of the 1934 Act supplies ample additional evidence that Congress meant what it said in limiting liability along the lines prescribed in Section 18, and intentionally crafted the interrelationships described above.

⁷ Further support for the proposition that Congress did not intend to expand the scope of recovery under Section 10(b) beyond the limits it placed in Sections 9(e) and 18(a) lies in the procedural restrictions on these express actions. For example, both sections include provisions authorizing courts to assess and require security for costs and attorneys' fees, 15 U.S.C. §§ 78f(e), 78r(a) (1982), and contain identical abbreviated statutes of limitations, requiring an action to be brought within one year of discovery of the facts constituting the cause of action but in no event later than three years after the cause of action has accrued, 15 U.S.C. §§ 78f(e), 78r(a) (1982). These procedural restrictions do not apply to judicially implied private actions under Section 10(b). See *Herman & MacLean v. Huddleston*, 459 U.S. at 384.

Although the legislative history of the 1934 Act is silent on the existence or ambit of any implied causes of action, see *Aaron v. SEC*, 446 U.S. at 690; *Touche Ross & Co. v. Redington*, 442 U.S. at 571, that history is not similarly silent on the scope of the express cause of action provided by Section 18. The legislative reports plainly indicate that liability in damages would not attach absent reliance on the offending statement, thus supporting the conclusion that Congress intended no lesser standard under Section 10(b). See *Ernst & Ernst v. Hochfelder*, 425 U.S. at 204.

Both the Senate Report⁸ and the House Report⁹ affirmed that liability and damages with respect to misleading statements contained in filed documents would lie in favor of "a person who in reliance on the statement and in ignorance of its false or misleading character has purchased the security to which it relates at a price affected by it" Moreover, the Senate Report further commented with respect to the express civil remedies provided in the 1934 Act that, "the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage." S. Rep. No. 792, 73d Cong., 2d Sess. 13 (1934) (quoted in *Ernst & Ernst v. Hochfelder*, 425 U.S. at 206) (emphasis added). Significantly, even in its general discussion of the need to regulate manipulative practices, the Senate Report contains no indication that liability is warranted absent such a showing of reliance. Cf. *Ernst & Ernst v. Hochfelder*, 425 U.S. at 205.

The congressional debates also focused on the unavailability of a civil damages remedy to a purchaser who did not rely on the allegedly misleading statements. See, e.g., 78 Cong. Rec. 7701, 8040 (1934). Indeed, an earlier formulation basing liability only upon the absence of good faith and proof that the stock price was affected by a misstatement was "very much challenged on the ground that reliance should be required." *Id.* at 7701. This record does not reflect congressional indifference to expanding the class of persons who could bring suit to

⁸ S. Rep. No. 792, 73d Cong., 2d Sess. 21 (1934).

⁹ H. R. Rep. No. 1383, 73d Cong., 2d Sess. 25 (1934).

include those who had not relied on the statement to their detriment, but rather speaks of a conscious intention to restrict the scope of liability to those who had relied. Conditioning liability upon an explicit showing of reliance was insisted upon, for example, by the sponsor of the bill, Chairman Rayburn of the House Committee on Interstate and Foreign Commerce:

Mr. HOLLISTER. The gentleman keeps referring to the issuer or the seller. This is a general clause and covers anybody making any kind of statement in any kind of document or in any kind of paper that is filed. It includes accountants, lawyers, or any other expert.

[A request for additional time was made.]

Mr. RAYBURN. I want to read this part of the section to the gentleman:

Who, in reliance upon the statement, shall have purchased or sold a security.

Mr. HOLLISTER. Yes; that is the man who is going to sue. I am talking about the report that is made. This refers to any statement that is made in any report under this bill, if it contains a misleading statement.

Mr. RAYBURN. *If upon that report somebody bought or sold a security and lost money relying upon the statement that was false.*

Id. at 8040 (emphasis added).

Even with the protections the requirement of reliance imposes, the draftsmen of the 1934 Act expressed the concern that Section 18(a) went too far. For example, Thomas Corcoran, one of its authors, criticized its long period of limitations, fearing that the threat of litigation long after the discovery of a misstatement would amount to "black-mail." *Hearings on S. Res. 84 (72d Cong.), S. Res. 56 and S. Res. 97 Before the Comm. on Banking and Currency, 73d Cong., 1st Sess., pt. 15, at 6565 (1934).* Similarly, the Institute itself expressed strenuous objection to the measure of damages originally provided. *Id.* at 7209. Although the Institute took exception to the possibility of damage awards far in excess of the actual loss sustained by an investor, the Institute recognized

that none of its members "would desire to deny or ignore his responsibility to those *who rely upon statements which he certifies*," as the express statutory remedy contemplated. *Id.* (emphasis added). These concerns were addressed by Congress, and the civil liability provisions of the 1934 Act and the 1933 Act were accordingly tightened. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 736, 740-41.

The decision below thus is not supported by the legislative history of the securities laws. Although that history is silent on the precise question of the scope of the remedy implied under Section 10(b), the absence of an affirmative indication that Congress considered the issue does not provide a license to divine an intent to create an implied remedy free of the requirement of reliance. As noted in *Touche Ross & Co. v. Redington*, "[I]mplying a private right of action on the basis of congressional silence is a hazardous enterprise, at best." 442 U.S. at 571. The Court went on to reason, in terms equally applicable here, regarding Section 17(a) of the 1934 Act, 15 U.S.C. § 78q (1982), that "where, as here, the plain language of the provision weighs against implication of a private remedy, the fact that there is no suggestion whatsoever in the legislative history that supports implication . . . reinforces our decision not to find such a right of action implicit within the section." *Id.* Even more telling are the explicit indications in the legislative history of Section 18 that Congress made a conscious policy choice in defining the contours of the express private damage remedy to include the requirement of reliance as an element of the cause of action.

* * *

In short, the fraud on the market theory of liability cannot be squared with the language of the 1934 Act, or with the cognate provisions of that statute and the 1933 Act, or with the relevant legislative history. It has no legitimate source in its supposed statutory antecedents and should be rejected.

II.

THE FRAUD ON THE MARKET THEORY ADOPTED BELOW IS UNSUPPORTED BY PRIOR DECISIONS OF THIS COURT OR THE ECONOMIC REALITIES OF THE MARKET AND HAS GENERATED TROUBLING INCONSISTENCIES AMONG THE LOWER COURTS.

A. *Affiliated Ute* Does Not Support The Result Reached Below.

Although the court below relies on numerous opinions from other circuit courts in support of the fraud on the market theory, notably absent from its analysis is any consideration of relevant Supreme Court authority, except for a passing reference to *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). See *Levinson v. Basic Inc.*, 786 F.2d 741, 750 (6th Cir. 1986). In fact, nothing in *Affiliated Ute* or any other pronouncement of this Court provides any support for the uncircumscribed presumption of reliance adopted below.¹⁰

Affiliated Ute involved two bank employees who, while acting in a fiduciary capacity as transfer agents on behalf of sellers of stock in a tribal corporation failed to disclose to those sellers, in face-to-face dealings, that the fiduciaries were also purchasers and market-makers for the resale of such securities. Because the record disclosed no evidence of reliance by the defrauded sellers on the defendants' misrepresentations, the Court of Appeals denied recovery. *Reynos v. United States*, 431 F.2d 1337, 1347 (10th Cir. 1970), *aff'd in part, rev'd in part sub nom. Affiliated Ute Citizens v. United States*, 406 U.S. 128

¹⁰ The Institute does not suggest that the court below relied directly on *Affiliated Ute* to support the fraud on the market theory, although that case was cited as supporting a presumption of reliance. The cases that first adopted this novel theory, however, did rely heavily on *Affiliated Ute*. See, e.g., *Blackie v. Barrack*, 524 F.2d at 908; *Panzirer v. Wolf*, 663 F.2d 365, 368 (2d Cir. 1981), *cert. granted sub nom. Price, Waterhouse & Co. v. Panzirer*, 458 U.S. 1105, *vacated as moot*, 459 U.S. 1027 (1982). The Sixth Circuit's reliance on those decisions, therefore, fairly raises the issue of whether their extension of the teaching of *Affiliated Ute* into a radically different factual context was warranted.

(1972).¹¹ Nevertheless, this Court found that the defendants' activities in reselling stock to non-tribe members at prices higher than offered to tribe members, in violation of agreements with the sellers, constituted a "course of business" or a "device, scheme or artifice" that operated as a fraud upon the sellers of the stock, creating liability under paragraphs (1) and (3), but not paragraph (2), of Rule 10b-5. *Affiliated Ute Citizens v. United States*, 406 U.S. at 152-53. On these facts, combining an affirmative duty to disclose and a total nondisclosure of material facts, this Court found proof of direct reliance unnecessary:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Id. at 153-54 (citations omitted).

Properly understood, *Affiliated Ute* does not relax the requirement of reliance as an element of a cause of action for damages based on a theory of misrepresentation. Rather, the decision allows a presumption of reliance upon proof of materiality because of the practical evidentiary problem of establishing by positive proof reliance upon a total nondisclosure. As the Second Circuit has observed, "[W]hat is important is to understand the rationale for a presumption of causation in fact in cases like *Affiliated Ute*, in which no positive statements exist: reliance as a practical matter is impossible to prove." *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92 (2d Cir. 1981) (citing 3 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* § 8.6(1),

¹¹ Although the Court of Appeals found no evidence of reliance, it did state, as this Court noted, 406 U.S. at 152, that the sellers relied upon the fiduciaries to handle properly the securities sales. *Reynos v. United States*, 431 F.2d at 1347. In this case, there is no suggestion, let alone a finding, that respondents placed comparable reliance on petitioners.

at 209 (1967), and Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 590 (1975)).

On the other hand, where the alleged securities fraud consists of misrepresentations of fact in or omissions from statements actually made, the plaintiff encounters no special difficulty in attempting to demonstrate reliance. In such circumstances, the doctrinal basis underlying the presumption of reliance allowed by *Affiliated Ute* is absent, and direct proof of reliance should be required. See Note, 88 Harv. L. Rev. at 590-92 (1975). A number of courts of appeals have recognized this analytical distinction and limited the reach of *Affiliated Ute* to cases involving a total non-disclosure of material information.¹²

The decision below cannot be legitimately viewed as involving silence or "primarily a failure to disclose," which *Affiliated Ute* required as a predicate for substituting proof of materiality for proof of direct reliance. The presumption *Affiliated Ute* allows in recognition of the evidentiary burden imposed by a requirement of proof of reliance upon a non-disclosure is unnecessary in these circumstances, where the allegedly misleading statements were issued and widely disseminated.¹³

¹² Compare, e.g., *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92-94 (2d Cir. 1981); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 547-48 (5th Cir. 1981), *aff'd in part, rev'd in part*, 459 U.S. 375 (1983) (on other issues); *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 717 (8th Cir. 1978); *Holdsworth v. Strong*, 545 F.2d 687, 695 (10th Cir.), *cert. denied*, 431 U.S. 955 (1976); with *Carras v. Burns*, 516 F.2d 251, 257 (4th Cir. 1975); and *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1048 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

¹³ The great majority of cases in which plaintiffs attempt to hold accountants liable involve allegations of misrepresentations or omissions in widely disseminated and commented upon documents so that plaintiffs would face no inherent problem of proof of reliance.

B. The Fraud On The Market Theory Is Premised On A Misunderstanding Of How The Financial Markets Function And Misuses The Concept Of Materiality Articulated By This Court.

The basic assumption underlying the fraud on the market theory is that any fact that is "material" to the singular hypothetical reasonable investor will inevitably be viewed by the entire market as sufficiently significant to distort the market price. As the court below put it:

When a defendant is shown to have made a material public misrepresentation that, if relied on directly, would fraudulently induce an individual to misjudge the value of the stock, the theory presumes that some investors did so rely and that the market price is distorted.

Levinson v. Basic Inc., 786 F.2d at 750. As this Court acknowledged in formulating a standard for materiality that recognized that a whole range of factors may affect investors' decisions, this simplistic assumption is contrary to the realities of the financial markets. See *TSC Indus. v. Northway Inc.*, 426 U.S. 439, 450 (1976).

Modern financial markets are structures of enormous complexity. Technological innovations combine with diverse economic incentives to create an environment in which participants receive a plethora of relevant information virtually simultaneously. See generally SEC Office of the Chief Economist, *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?* (Feb. 24, 1987). To assume that the effect on price of any one piece of information can be isolated and determined is to engage in a fiction. By definition, an efficient market is able to process accurately the collective and differing views of thousands of traders reacting to a rapid influx of changing information of varying degrees of importance and reliability. See E. Fama, *Foundations of Finance* 133 (1976). Such a process is not

analogous to the hypothetical reasonable man weighing the significance of a single isolated piece of information.¹⁴

Whether a particular fact is material to an investor is dependent on what other information he has available to him. To presume that a press release has the same relevance to an ordinary investor as it has to an arbitrageur is to ignore reality. Similarly, the assumption that all significant facts are catalysts to action is flawed. Although an investor would want to know of a potential acquisition, he might not determine immediately what action, if any, he wished to take based on that fact. Furthermore, even if one assumes that a particular fact would induce action on behalf of some investors, it is yet another logical leap to the assumption that enough parties will act to affect the market price, or that all investors will react in the same way.¹⁵

Viewed in the context of the complex matrix of factors that may affect market price, the decision below demonstrates that

¹⁴ The decision below speaks of two separate assumptions on which it purports to rest: (1) that in an efficient market, the price of a stock reflects all information available to the public; and (2) that an individual relies on the integrity of the market price when dealing in a stock. 786 F.2d at 750. Under that formulation it is unclear precisely what is meant by the "integrity" of the market price. Certainly, traders do not universally believe market prices are accurate. Most purchasers are presumably acting on a belief the price is too low, while sellers believe the price is too high. Nor do most traders believe the price is an accurate reflection of all public information. If that were the case, their trades would only be rational when based on inside information.

¹⁵ The Ninth Circuit, the first court of appeals to adopt the fraud on the market theory in *Blackie v. Barrack*, has more recently held that "not everything which might affect price or value is material" *Grigsby v. CMI Corp.*, 765 F.2d 1369, 1376 (9th Cir. 1985). In that case, a parent corporation did not disclose negotiations for its sale in connection with its purchase of the stock of minority shareholders. Although the shareholders argued that such information affected the value of their stock, the court ruled against them. See also *Dower v. Mosser Indus.*, 488 F. Supp. 1328, 1340-41 (E.D. Pa. 1980), *aff'd*, 648 F.2d 183 (3d Cir. 1981) (speculation on how sale of a parent could affect subsidiary's value does not meet materiality requirements; disclosure was likely to confuse minority stockholders).

the controlling assumption of the fraud on the market theory does not accurately describe how an efficient market works. The opinion is perhaps most inaccurate in its willingness to accept the assumption that an "efficient" market remained distorted for fourteen months because a company released a handful of isolated "no corporate developments" announcements in the face of merger rumors and heavy market trading. As financial experts have stated:

An efficient market is one in which a large number of buyers and sellers react through a sensitive and efficient mechanism to cause market prices to reflect fully and *virtually instantaneously* what is knowable about the prospects for the companies whose securities are being traded.

J. Lorie & M. Hamilton, *The Stock Market: Theories and Evidence* 97 (1973) (emphasis added).

Although it is not unreasonable to believe that some of the Basic announcements were considered material by some investors, those investors with the greatest impact on the market's volume of trading, and therefore the greatest willingness to pay for information, would soon receive and act upon other information—analysts' reports, rumors and other market transactions themselves. It is those investors who most influence market price. See Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law 1, 4 (1982).

This Court's careful formulation of the meaning of materiality in *TSC Indus. v. Northway, Inc.*, 426 U.S. 439 (1976), demonstrates its appreciation of the many variables that may affect investment decisions. The decision below and other fraud on the market cases misuse the materiality concept, however, by extrapolating from the finding that information is material to the singular hypothetical reasonable investor to a conclusion that the entire market will act on that information—a leap of faith that experience demonstrates is unwarranted.

In the context of proxy contests,¹⁶ this Court defined the concept of materiality by stating "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indus. v. Northway, Inc.*, 426 U.S. at 449.¹⁷ In applying this principle, courts have recognized that information that might be deemed significant in some circumstances may not be material in the context of other information available through a variety of sources. See, e.g., *Kademian v. Ladish Co.*, 792 F.2d 614, 622-26 (7th Cir. 1986); *Flynn v. Bass Bros. Enter.*, 744 F.2d 978, 989-90 (3d Cir. 1984); *Kin-Ark Corp. v. Boyles*, 593 F.2d 361, 366-67 (10th Cir. 1979).

TSC Industries further stated that materiality "does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote." 426 U.S. at 449. This Court went on to point out that a determination of materiality presents mixed questions of law and fact. Thus, it would be a rare case when " 'reasonable minds cannot differ' on the question of materiality" to the extent that it could be established as a matter of law on summary judgment. 426 U.S. at 450 (quoting *Johns Hopkins University v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974)).

As interpreted in the Sixth Circuit's decision below and other fraud on the market cases, however, a fact that satisfies the legal prerequisites of materiality, i.e., one that is likely to be viewed as significant by a reasonable investor in the perspective of other information available to him, will inevitably be viewed as material by the entire market and lead to a change in market

¹⁶ Although *TSC Industries* involved a proxy statement and an alleged violation of Section 14(a) of the 1934 Act, its formulation of the standard for materiality has been widely accepted in cases under Section 10(b) and Rule 10b-5. See, e.g., *Toombs v. Leone*, 777 F.2d 465 (9th Cir. 1985); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978).

¹⁷ The Court pointed out that this definition was supported by the SEC as striking the proper balance between encouraging disclosure and maintaining a reasonable threshold for civil liability. *TSC Indus.*, 426 U.S. at 449-50 n.10.

price. See, e.g., *Blackie v. Barrack*, 524 F.2d at 906 ("Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price . . .").

Thus, an inquiry that this Court took great pains to explain was highly fact-specific has been reduced to a simple binary determination: a fact is either material to all investors for all purposes or it is not. If a trial judge believes a misleading statement is material, that opinion is converted into a presumption that the entire market shared that view and acted on it.¹⁸ Nothing in *TSC Industries* remotely suggests that this Court intended a finding of materiality to have such an impact.

C. The Inherent Flaws In The Fraud On The Market Theory Are Exposed By Its Inconsistent And Confused Application In The Lower Courts.

While the federal courts of appeals have nominally accepted the fraud on the market theory to facilitate access to private damage actions under Rule 10b-5 and to the class action mechanism in particular, the application of this theory has engendered little consistency and much confusion.

In *Blackie v. Barrack*, 524 F.2d at 906, the Ninth Circuit adopted the fraud on the market theory in the impersonal stock exchange context, presuming reliance on misrepresentations based on proof of purchase and proof of materiality. The Fifth Circuit went beyond *Blackie* in extending the theory to new securities issued in an undeveloped market, but at the same time rejected the Ninth Circuit's view that reliance on market price can be substituted for reliance on the particular

¹⁸ The Institute recognizes that courts have referred to the materiality standard set out in *TSC Industries* as an objective one because of its reference to a "reasonable" investor. See, e.g., *Fisher v. Plessey Co.*, 103 F.R.D. 150, 155 (S.D.N.Y. 1984); *SEC v. National Student Mktg. Corp.*, 457 F. Supp. at 708. It has also been judicially recognized, however, that although the standard may be objective, the significance a reasonable investor gives to a particular fact depends on all of the circumstances confronting him. *Michaels v. Michaels*, 767 F.2d 1185, 1197 (7th Cir. 1985), *cert. denied*, ___ U.S. ___, 106 S. Ct. 797 (1986); see also 5A A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 61.02[b][ii], at 3-131 (1987) ("the hypothetical reasonable man should be presumed to be standing in the plaintiff's shoes").

misrepresentation alleged. *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983). Thus, the Fifth Circuit dismissed a Rule 10b-5 claim based on alleged misstatements in an offering circular on the ground that the plaintiff admitted he had never read that document, allowing the case to proceed only on the claim that defendants had perpetrated an elaborate fraud on plaintiff and the market by selling securities that were unmarketable to a party who was willing to accept only marketable risks. 647 F.2d at 468-69.¹⁹

The facts and legal theory of the leading opinion in the Second Circuit differ markedly from both the Third and Ninth Circuit cases. In *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *cert. granted sub nom. Price Waterhouse & Co. v. Panzirer*, 458 U.S. 1105, *vacated as moot*, 459 U.S. 1027 (1982), the plaintiff did not even allege any reliance on the integrity of market prices. Instead, in an action against an accounting firm, among others, she claimed that a "fraud on the market" had been perpetrated because a newspaper article that purported to be based on a company's financial statements conveyed a misleading picture of the company's financial health.

Perhaps the confusion among the various circuits is most clearly seen in connection with the issue of how defendants can rebut the presumption of reliance. The Sixth Circuit's suggestion that it can be rebutted by disproving the elements that establish the presumption only confuses the issue of burden of proof on those elements. That court also suggests that the presumption can be rebutted by a showing that an insufficient number of people relied on the misrepresentation. This suggestion is meaningless in light of the theory's underlying assumption that all transactions are entered into to some degree in reliance on the integrity of the market price. Finally, the suggestion that defendants can overcome the presumption by demonstrating that plaintiffs would have traded even if the misrepresentation had not occurred merely shifts to defendants

¹⁹ Relying on *Shores*, the court in *Fausett v. American Resources Mgt. Corp.*, 542 F. Supp. 1234, 1238 (D. Utah 1982) flatly rejected the fraud on the market theory as a substitute for reliance in fact, stating, "It is not the prerogative of the courts to substitute their preferred method of achieving the purposes of a statute for that of Congress." *Id.*

the metaphysically insurmountable burden of proof that led this Court to create the limited presumption of reliance in *Affiliated Ute*. See 786 F.2d at 750 n.6.

Not surprisingly, the earlier cases provide no more meaningful answers. Although *Blackie*, *Panzirer* and *Shores* suggest the presumption is rebuttable, they offer no more realistic approaches, and seemingly concede that the presumption is irrebuttable on motions for class certification. *Blackie v. Barrack*, 524 F.2d at 906-07 n.22; *Panzirer v. Wolf*, 663 F.2d at 367; *Shores v. Sklar*, 647 F.2d at 468. It is certainly the case that once a class is certified, the costs of pursuing the illusory relief the opinions proffer becomes prohibitive. Thus, a presumption allegedly established to overcome a nonexistent problem of proof is transformed into a *de facto* partial summary judgment for plaintiff on a crucial element of the Rule 10b-5 claim.

III.

THE DECISION BELOW IMPOSES POTENTIAL LIABILITY OF UNLIMITED SCOPE IN DEROGATION OF THE POLICIES UNDERLYING THE SECURITIES LAWS AS ANNOUNCED BY THIS COURT.

The rule adopted by the Court of Appeals not only distorts beyond recognition the type of reliance that Congress so plainly intended and expands beyond reason this Court's holding in *Affiliated Ute*, but it also subverts other elemental principles of the securities laws and would allow liability to be imposed on the very sort of speculative basis condemned by this Court. The potential consequences of such an extension of liability on the accounting profession are profoundly disturbing and show that such a rule is improvident.

The court below speaks of statements that "induce" reliance by investors. 786 F.2d at 750. The universe of such statements encompasses everything from brokerage house investment letters and newspaper financial columns to television shows and rumors on the street. Any such statements can induce the reliance of investors; indeed many are intended to do so. This

Court has recognized that the federal securities laws do not provide an insurance scheme for investors who react to this information flow. See *Dirks v. SEC*, 463 U.S. 646, 667 n.27 (1983) ("as market values fluctuate and investors act on inevitably incomplete or incorrect information, there always are winners and losers; but those who have 'lost' have not necessarily been defrauded"). The decision below, however, would lead to precisely that result. By permitting investors whose investment decisions turn sour to point to any allegedly misleading statements that occurred prior to their decision—regardless of their knowledge of, much less their reliance on, such statements—the decision below would create a whole new class of plaintiffs whose refuge in the securities laws was not contemplated by Congress nor countenanced by prior decisions of this Court.

Accountants, in particular, are likely to find themselves inviting targets for such suits. Indeed, plaintiffs now commonly seek recovery from accountants on a fraud on the market theory.²⁰ Moreover, when a company fails, its creditors and investors frequently name the company's auditors as a defendant and expect full recovery from the auditors for their losses. Although the company and its management are often more responsible for alleged misstatements in financial statements prepared by the company than are the accountants who

²⁰ There are at least twenty-three such cases reported, all of which were brought as class actions. See *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), cert. granted sub nom. *Price Waterhouse & Co. v. Panzirer*, 458 U.S. 1105, vacated as moot, 459 U.S. 1027 (1982); *Rifkin v. Crow*, 574 F.2d 256 (5th Cir. 1978); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); *Starrels v. First Nat'l Bank*, No. 85-C-6458 (N.D. Ill. Jan. 21, 1987) (LEXIS, Genfed Library, Dist File); *Rothfarb v. Hambrecht*, 649 F. Supp. 183 (N.D. Cal. 1986); *In re Storage Tech. Corp. Sec. Litig.*, 630 F. Supp. 1072 (D. Colo. 1986); *Michaels v. Ambassador Group, Inc.*, 110 F.R.D. 84 (E.D.N.Y. 1986); *Rosenberg v. Digilog Inc.*, 648 F. Supp. 40 (E.D. Pa. 1985); *Stoller v. Baldwin-United Corp.*, No. C-1-82-1438 (S.D. Ohio June 4, 1985) (LEXIS, Genfed Library, Dist File); *Reingold v. Deloitte Haskins & Sells*, 599 F. Supp. 1241 (S.D.N.Y. 1984); *Augenstein v. McCormick & Co.*, 581 F. Supp. 452 (D.Md. 1984); *Greenwald v. Integrated Energy*,

(footnote continued)

audit those statements, the company's insolvency and management's limited individual assets render them unable to satisfy potentially enormous damage claims. Thus, their accountants, who usually practice with appropriate liability insurance, become the "deep pockets" who attract the lawsuit.²¹

These concerns led this Court in *Ernst & Ernst v. Hochfelder* to reject an interpretation of Rule 10b-5 that, by weakening the *scienter* requirement, "would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the [Securities] Acts." 425 U.S. at 214 n.33. In condemning any such expansion of the permissible scope of recovery, this Court found support in its earlier statement in *Blue Chip Stamps v. Manor Drug Stores*, which in turn relied upon a landmark decision by then Chief Judge Cardozo:

"While much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of

(continued footnote)

Inc., 102 F.R.D. 65 (S.D. Tex. 1984); *In re Data Access Syst. Sec. Litig.*, 103 F.R.D. 130 (D.N.J. 1984); *In re Nucorp Energy Sec. Litig.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,157 (S.D. Cal. Mar. 24, 1983); *Cohen v. Laiti*, 98 F.R.D. 581 (E.D.N.Y. 1983); *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730 (W.D. Va. 1982); *Markewich v. Ersek*, 98 F.R.D. 9 (S.D.N.Y. 1982); *Beissinger v. Rockwood Computer Corp.*, 529 F. Supp. 770 (E.D. Pa. 1981); *Kennedy v. Nicastro*, 517 F. Supp. 1157 (N.D. Ill. 1981); *In re LTV Sec. Litig.*, 88 F.R.D. 134 (N.D. Tex. 1980); *Kornick v. Talley*, 86 F.R.D. 715 (N.D. Ga. 1980); *Tanzer v. Sharon Steel Corp.*, 27 Fed. R. Serv. 2d (Callaghan) 1338 (S.D.N.Y. 1979); *Tucker v. Arthur Andersen & Co.*, 67 F.R.D. 468 (S.D.N.Y. 1975).

²¹ As noted in a recent report by senior Administration officials of eleven federal agencies, the "deep pocket" effect has been empirically corroborated. Tort Policy Working Group, *An Update on the Liability Crisis* 54 n.75 (Mar. 1987) (citing A. Chin & M. Peterson, *Deep Pockets, Empty Pockets: Who Wins in Cook County Jury Trials* (1985)).

plaintiffs who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate class':

'The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.' *Id.*, at 179-80, 174 N.E., at 444."

Ernst & Ernst v. Hochfelder, 425 U.S. at 214-15 n.33 (quoting *Blue Chip Stamps*, 421 U.S. at 747-48).

The dangers inherent in broadening the class of plaintiffs in Section 10(b) actions are heightened when the presumption of reliance is used to circumvent the predominance requirement of Rule 23(b)(3).²² This Court has recognized that, "Certification of a large class may so increase the defendant's potential damages liability and litigation costs that he may find it economically prudent to settle and to abandon a meritorious defense." *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 476 (1978). This *in terrorem* economic effect of the pendency of even the most meretricious litigation, coupled with the cloud cast upon the professional reputation and standing of accountants defending liability actions, creates a settlement value in such lawsuits bearing no relationship to the real quantitative size or qualitative merit of the claim.

The prospect of strike suits brought as class actions poses a particular threat when brought under Section 10(b), which lacks the procedural restrictions, such as an abbreviated statute of limitations and an allowance for the recovery of attorneys'

²² In utilizing this mechanism to facilitate class certification, the lower courts have universally failed to consider adequately the admonition contained in the comments of the advisory committee on Rule 23 recognizing that, "[A] fraud case may be unsuited for treatment as a class action if there was material variation in the representations made or in the kinds or degrees of reliance by the persons to whom they were addressed." Fed. R. Civ. P. 23(b)(3) advisory committee note (1966 Amendments).

fees, provided for by Sections 9(e) and 18(a) of the 1934 Act. Moreover, while the court below purported to allow defendants to rebut a presumption of reliance in Section 10(b) actions, this is not a realistic option given the practical difficulties and expenses associated with such a showing in a class action.

The court below disregarded these concerns and adopted a rule of law that suffers from precisely the "flaw" about which Chief Judge Cardozo warned. The consequences of the Court's decision must be weighed not only in the isolated circumstances of this case, but in terms of all the cases to come. As noted in *Ernst & Ernst v. Hochfelder*, "The class of persons eligible to benefit from such a standard, though small in this case, could be numbered in the thousands in other cases." 425 U.S. at 215-16 n. 33. Here, as there, "Acceptance of respondents' view would extend to new frontiers the 'hazards' of rendering expert advice under the [Securities] Acts, raising serious questions not yet addressed by Congress." *Id.*

Nor can it seriously be suggested that the interests of the investing public are well-served by the extension of Rule 10b-5 liability permitted below. Indeed, the exposure to "large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers," *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969), is entirely inappropriate in view of the attendant social costs. Congress has already measured with care the appropriate scope of liability that it decided was necessary to serve the public interest and to achieve its regulatory ends. The decision below effectively supplants that collective judgment, and will upset in practice as well as in theory the calculus of risk and precaution that Congress concluded was appropriate.

CONCLUSION

The order of the Court of Appeals for the Sixth Circuit should be reversed insofar as it upheld the Order of the District Court granting class certification.

Dated: April 30, 1987

Respectfully submitted,

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AMICUS CURIAE

BRIEF

MOTION FILED
SEP 15 1987

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS,
JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER,
H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C.
WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as
trustee under the Karl Zuckerman Revocable Trust,
and RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

**MOTION OF JOSEPH HARRIS, HENRY PUCHALL, ESTATE
OF MARVIN FRANKEL, HOWARD SHELDON, MARTIN
WOOLIN, MARIE LONGO, JAMES LONGO, ADELAID
BRISKMAN, AND BURTON ROSENFELD FOR LEAVE
TO FILE *AMICI CURIAE* BRIEF OUT OF TIME, AND
AMICI CURIAE BRIEF IN SUPPORT OF RESPONDENTS**

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IN THE

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BRISKMAN, AND BURTON ROSENFELD FOR LEAVE
TO FILE *AMICI CURIAE* BRIEF OUT OF TIME**

Joseph Harris, Henry Puchall, Estate of Marvin Frankel,
Howard Sheldon, Martin Woolin, Marie Longo, James
Longo, Adelaid Briskman, and Burton Rosenfeld, (the
“Investor *Amici*”), hereby move the Court for leave to
make a late filing of the accompanying *amici curiae* brief
addressing the “fraud-on-the-market” issue.

Interest Of The Investor *Amici* And Grounds For The Motion

Henry Puchall, Joseph Harris, Estate of Marvin Frankel, Howard Sheldon and Martin Woolin are plaintiffs in *In re Washington Public Power Supply Systems Securities Litigation* ("WPPSS"), M.D.L. 551, 623 F. Supp. 1466 (W.D. Wash.), 650 F. Supp. 1346. In WPPSS, persons who invested \$2.25 billion in municipal bonds seek recovery for losses suffered when prior misrepresentations and omissions came to light and the bonds lost 90% of their value.

Marie Longo and James Longo are plaintiffs in *Longo, et al. v. Frederick H. Jarvis, et al.*, 82 Civ. 2880 (MAC) and 82 Civ. 3198 (MAC), United States District Court for the Eastern District of New York. *Longo* is an action on behalf of persons who sold common shares while deceptive statements were being made which artificially depressed the market price of the stock, including statements which omitted to disclose merger discussions. Damages are estimated to exceed \$50 million.

Adelaid Briskman is a plaintiff in *Briskman v. The Upjohn Company, et al.*, 86 Civ. 3625, United States District Court for the Eastern District of Pennsylvania. *Briskman* is a class action on behalf of persons who bought common shares while defendants issued deceptive statements regarding a new drug, thereby inflating the market price of the stock. Damages are estimated to exceed \$10 million.

Burton Rosenfeld is a plaintiff in *Rosenfeld v. Home Shopping Network, Inc., et al.*, Case No. 87-428, Civ-T-13(a), United States District Court for the Middle District of Florida, Tampa Division. *Rosenfeld* is a class action on behalf of persons who bought shares while defen-

dants issued deceptive statements which distorted the market price of the stock. Damages are estimated to exceed \$50 million.

Each of these cases arises under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and involves the fraud-on-the-market doctrine.

The Investor *Amici* represent a cross-section of the thousands of private investors who must rely on the securities laws for redress when confronted with open market fraud. Each of the Investor *Amici*, as well as investors across the country generally, would be vitally and adversely affected by a decision of this Court rejecting or questioning the fraud-on-the-market doctrine.

The attached brief contains a number of important arguments which have not yet been presented to the Court. A presentation by a cross-section of investors is especially desirable since this Court has already received three *amicus curiae* briefs from groups whose members have a strong personal interest in emasculating Section 10(b). While the Securities and Exchange Commission (the "SEC") has made a presentation, there is no private group or institution before the Court supporting the fraud-on-the-market doctrine in an *amicus curiae* brief. As the SEC recognizes, it is in private actions that the fraud-on-the-market doctrine is an issue.

The Investor *Amici* present a unique perspective in arguing, among other things, that this is not an appropriate case for the Court to consider the sweeping change in the law for which petitioners contend. The case is dominated by a separate issue that has garnered most of the attention of the parties; there is no final decision below which turned on the fraud-on-the-market doctrine; and the fac-

tual nature of this case is atypical with respect to fraud-on-the-market cases generally.

Alternatively, however, if the Court is to consider such a dramatic shift in the law, the views of Investor *Amici* should be heard, particularly where the Court has before it the views of several securities defense groups.

Counsel for respondents have consented to the filing of the enclosed brief. The Investor *Amici* have sought the consent of petitioners to the filing of the enclosed brief, but petitioners have refused consent.

Request For Leave To File Brief Out Of Time

Investor *Amici* regret that they were not aware that the Court had granted *certiorari* with regard to the fraud-on-the-market issue until the normal time for filing an *amicus* brief in support of respondents had run. However, acceptance of the enclosed brief would cause no prejudice to any party or to the Court's docket. Oral argument will not occur until November 2. Petitioners have until one week before oral argument to file their reply brief, in which they can rebut Investor *Amici's* brief as necessary. Thus, Investor *Amici's* tardiness is non-prejudicial.

Consequently, Investor *Amici* respectfully request that this Court allow a late filing of this brief.

For the foregoing reasons, the motion of the Investor *Amici* for leave to file the accompanying brief as *amici curiae* in support of respondents should be granted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

BASIC INCORPORATED, ANTHONY M. CAITO, SAMUEL EELLS, JR., JOHN A. GELBACH, HARLEY C. LEE, MAX MULLER, H. CHAPMAN ROSE, EDMUND Q. SYLVESTER and JOHN C. WILSON, JR.,

Petitioners,

—v.—

MAX L. LEVINSON, KARL ZUCKERMAN, individually and as trustee under the Karl Zuckerman Revocable Trust, and RONALD M. NEWMAN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR AMICI CURIAE JOSEPH HARRIS, HENRY PUCHALL, ESTATE OF MARVIN FRANKEL, HOWARD SHELDON, MARTIN WOOLIN, MARIE LONGO, JAMES LONGO, ADELAID BRISKMAN, AND BURTON ROSENFELD IN SUPPORT OF RESPONDENTS

Interest Of The Amici Curiae

The *amici curiae* herein are a cross section of investors who are currently participating in major securities actions where the fraud-on-the-market issue is involved. Like thousands of other investors who are relying on the fraud-

on-the-market doctrine in their prosecution of cases under Section 10(b) of the Securities Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78j(b), they have a vital interest in the outcome of this Court's consideration of that doctrine. The individual Investor *Amici* and their interest in this case are described in detail in the accompanying motion for leave to file this brief.

Introduction And Summary Of Argument

The Investor *Amici* submit that the fraud-on-the-market doctrine is an eminently appropriate interpretation of Section 10(b). That doctrine does not dispense with the requirement of reliance. Rather, it interprets that requirement in the context of publicly traded securities, in a manner consistent with the way in which investment decisions are actually made. The doctrine has achieved overwhelming acceptance by courts across the country because it is a sensible and efficient approach to the reliance requirement where a fraud is committed which affects the market for a security generally. While the doctrine is not limited to class actions, it has provided a sound rationale for the conclusion—reached by virtually all courts which have considered the issue—that the reliance requirement under Section 10(b) does not create predominating individual issues preventing class certification.

Petitioners and the three *amici* opposing the fraud-on-the-market doctrine misdescribe the doctrine in contending that it dispenses with proof of causation or damages. They also resort to numerous extraneous arguments (such as the alleged need for auditors to be insulated from securities fraud suits and their request for relief from the normal measure of damages) which have little relevance to this Court's consideration of the fraud-on-the-market doctrine.

In particular, the Court should reject the attack of petitioners and their supporting *amici* on securities class actions. As recognized by many courts and commentators, investor class actions are crucial to enforcement of the securities laws. They constitute the only vehicle through which most investors can afford to seek redress when they have been defrauded, and through which honest markets can be maintained.

Furthermore, the Investor *Amici* respectfully suggest that this case does not squarely present the fraud-on-the-market doctrine as an issue of law appropriate for this Court's *certiorari* review. What is presented is a non-final, discretionary determination under Rule 23, Fed. R. Civ. P., reversible only upon a showing of abuse of discretion. The fraud-on-the-market doctrine, if appropriate for this Court's review, should await a case directly presenting the issue, such as one in which recovery has been granted based upon acceptance of the doctrine or denied because of its rejection. Petitioners themselves contend that this case is atypical with respect to the fraud-on-the-market doctrine, since it involves defrauded sellers rather than purchasers and a 14 month class period. Furthermore, the fraud-on-the-market doctrine is of such pervasive importance that it should be considered, if at all, in a case solely dealing with that issue, not in a case where the primary attention of the parties is directed elsewhere.

ARGUMENT

I.

The Fraud-On-The-Market Doctrine Should Be Approved As A Sound And Reasonable Application Of The Reliance Requirement Which Comports Well With The Congressional Policy Of Private Enforcement Of The Securities Laws.

A. The Fraud-On-The-Market Doctrine Does Not Dispense With The Reliance Requirement; It Constitutes A Sensible And Realistic Interpretation Of That Requirement Which Has Been Accepted By Virtually Every Court To Consider It, And Which Is Supported By Overwhelming Empirical Data.

The fraud-on-the-market theory was initially adopted in *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), and has since been approved in every circuit which has addressed the question.¹ It has also been widely applauded in law review articles.²

¹ E.g., *Flamm v. Eberstadt*, 814 F.2d 1169, 1179-80 (7th Cir. 1987); *Finkel v. Docutel/Olivetti Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,281 (5th Cir. May 27, 1987); *Peil v. Speiser*, 806 F.2d 1154, 1160-63 (3d Cir. 1986); *Lipton v. Documentation, Inc.*, 734 F.2d 740, 745-48 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot*, 459 U.S. 1027 (1982); *Wachovia Bank & Trust Co., N.A. v. National Student Marketing Corp.*, 650 F.2d 342, 358 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981); *Ross v. A.H. Robins Co. Inc.*, 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

² See, e.g., Easterbrook and Fischel, *The Proper Role of A Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1165-67 (1981); Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Se-*

(footnote continued on following page)

Petitioners and their supporting *amici* attack the fraud-on-the-market doctrine primarily on the ground that it dispenses with the judicially created reliance requirement in Section 10(b) cases. To the contrary, the fraud-on-the-market doctrine simply recognizes that frequently, rather than relying on specific statements made by defendants, investors rely on the integrity of the process through which the market price of the security involved is established. Given an essentially efficient market where material misrepresentations will normally have a distorting effect on the market price of the security, there is no reason why reliance on the integrity of the market should not be accepted as a form of reliance supporting recovery where open market fraud has occurred. If the market has been defrauded (and the price inflated), the investors have been defrauded as well, whether or not they personally read the fraudulent statement.

The classic statement of the rationale for the fraud-on-the-market theory appears in *Blackie v. Barrack*, 524 F.2d at 906:

Moreover, proof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market. See *Herbst v. I.T.T.*, *supra* at 1315-1316; *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 373-374 (2d Cir. 1973); *Tucker v. Arthur Andersen & Co.*, 67 F.R.D. 468, at 480 (S.D.N.Y. 1975); *U.S. Financial Securities Litigation*, *supra*, at

(footnote continued from previous page)

securities, 38 Bus. Lawyer 1, 9-10 (1982) ("[T]his central assumption of the fraud-on-the-market theory—the efficiency of stock prices—has been demonstrated by a multitude of studies.") (footnote omitted). Note, *The Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143 (1982); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-3*, 50 Geo. Wash. L. Rev. 627 (1982).

449-451; *Werfel v. Kramarsky*, *supra*, at 681; *In re Memorex Security Cases*, *supra*, at 100-101; *Siegel v. Realty Equities Corporation of New York*, *supra*, at 424-425; *Herbst v. Able*, *supra*, at 20. Proof of reliance is adduced to demonstrate the causal connection between the defendant's wrongdoing and the plaintiff's loss. We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causal chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a *prima facie* case. See *In re Memorex Security Cases*, *supra*, at 101; Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv.L.Rev. 584, 593 (1975).

In *Blackie*, the Ninth Circuit stressed that the fraud-on-the-market doctrine would *not* allow a recovery "solely on a showing of economic damage (loss causation)." Rather, the Ninth Circuit stressed,

We merely recognize that individual "transactional causation" can in these circumstances be inferred from the materiality of the misrepresentation, *see Tucker v. Arthur Andersen & Co.*, *supra*, at 480; *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 381-382 (2d Cir. 1974), and shift to defendant the burden of disproving a *prima facie* case of causation. Defendants may do so in at least 2 ways: 1) by disproving materiality or by proving that, despite materiality, an insufficient number of traders relied to inflate the price; and 2) by proving that an individual plaintiff pur-

chased despite knowledge of the falsity of a representation, or that he would have, had he known of it. (footnote omitted).

Id.

As described in *Blackie*, the fraud-on-the-market doctrine is based on the entirely sensible assumption that the reasonable investor relies on the integrity of the process by which the market price has been set in an open market situation:

A purchaser on the stock exchanges may be either unaware of a specific false representation, or may not directly rely on it; he may purchase because of a favorable price trend, price earnings ratio, or some other factor. Nevertheless, he relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price—whether he is aware of it or not, the price he pays reflects material misrepresentations. Requiring direct proof from each purchaser that he relied on a particular representation when purchasing would defeat recovery by those whose reliance was indirect, despite the fact that the causal chain is broken only if the purchaser would have purchased the stock even had he known of the misrepresentation. We decline to leave such open market purchasers unprotected. The statute and rule are designed to foster an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely.

Id. at 907.

Under the fraud-on-the-market theory, a plaintiff makes out a *prima facie* case if he proves that a defendant having

scienter made a material misrepresentation which would cause a reasonable investor to purchase at a price that distorts the value of the securities involved. The burden is then on the defendants to show that the misstatements were not material, not made with *scienter*, that the individual plaintiff would have acted no differently had he known the truth, or that the misleading statements did not affect the price of the securities because an insufficient number of investors traded in reaction to the misleading statements. *Levinson v. Basic*, 786 F.2d 741, 750 (6th Cir. 1986).

The fraud-on-the-market theory receives strong support from this Court's decision in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972). In a case involving primarily a failure to disclose material facts, this Court held that the plaintiff was not required to prove reliance on misstatements or omissions to sustain a claim under Section 10(b), stating "[t]his obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." 406 U.S. at 154. (Citation omitted).

Petitioners argue that *Affiliated Ute* involves only a failure to disclose and does not apply to cases involving affirmative misrepresentations. However, there is no sound reason to distinguish between cases primarily involving omissions and cases involving materially misleading statements. The latter are often "half-truths", and it is the omission of some material fact which renders them misleading. Given the "functionally identical" nature of omissions and most materially misleading statements (*Flamm v. Eberstadt*, 814 F.2d at 1172-73), the reasoning in *Affiliated Ute* is applicable to misleading statements generally.

Furthermore, the basis upon which petitioners attempt to distinguish *Affiliated Ute* would place a more onerous burden of proof on a plaintiff where the defendant has

gone out of his way to affirmatively misrepresent the facts than where the defendant has made no statement whatsoever.³ This approach gives the defendant an advantage in a fraud suit involving affirmative misrepresentations where such advantage is wholly unjustified by the nature of his wrongdoing.

The conclusion that reliance on the integrity of the market constitutes sufficient reliance under Section 10(b) is also supported by the specific language of that section. Under Section 10(b), it is unlawful to use or employ "any manipulative or deceptive device or contrivance" in contravention of the rules of the SEC. The word "manipulative" in Section 10(b) connotes conduct "designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (emphasis added) (footnote omitted); see also *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977). Given that definition, reliance on the market price, or upon the integrity of the process by which the market price was established, should be sufficient to sustain a claim under Section 10(b).

The "efficient market" concept upon which the fraud-on-the-market theory rests—i.e., the concept that the market price of a security will typically reflect the material information which has been made public relating to the company and the security—is grounded in numerous empirical studies, and has been widely accepted by experts in the functioning of the securities markets.⁴ See, e.g., *In re LTV*

³ Concern with respect to jury confusion arising from a different burden with respect to misleading statements on the one hand and material omissions on the other was expressed in *Flamm v. Eberstadt*, 814 F.2d at 1173-74.

⁴ E.g., Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Lawyer 1, 9-10 (1982); Gibson & Kraakman, *The Mechanisms of Market* (footnote continued on following page)

Securities Litigation, 88 F.R.D. 134, 142-46 (N.D. Tex. 1980).

Even petitioners and their supporting amici do not seriously contend that the "efficient market" concept is not generally accepted. They themselves actually rely on the "efficient market" concept for some of the arguments made in their briefs.⁵ Furthermore, the same securities-defense groups urging the Court to do away with the fraud-on-the-market doctrine often defend such cases upon what is known as the "efficient market defense." They argue that plaintiff class members who purchased after a curative disclosure by the issuer or others cannot recover, even if

(footnote continued from previous page)

Efficiency, 70 Va. L. Rev. 549, 551 (1984); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 Geo. Wash. L. Rev. 627, 637 n.52 (1982); Fama, *Foundations of Finance, Portfolio Decisions and Securities Prices*, 320-82 (1976); Lorie & Hamilton, *The Stock Market: Theories and Evidence*, 70-97 (1973); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 Stan. L. Rev. 1031, 1034-57 (1977).

⁵ For example, Amicus American Corporate Counsel Association ("ACCA") argues that the fraud-on-the-market doctrine is especially inappropriate in the context of merger negotiations because the efficient market is so efficient that it is typically informed of prospective mergers and takeovers before they are announced. ACCA Br., pp. 8-10. By stressing that the efficient market actually works, however, ACCA and the other amici supporting petitioners actually concede the sound factual basis for the fraud-on-the-market doctrine. Furthermore, if, in a particular case, sufficient information concerning merger negotiations was in the market place to offset the deceptive statements of defendants, the fraud-on-the-market theory would not result in liability because defendants' statements would either be held immaterial in light of the "total mix" of information coming to the attention of investors (*ISC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *Spielman v. General Host Corp.*, 538 F.2d 39 (2d Cir. 1976) or defendants would proffer evidence through "market impact" experts or testimony of traders and research analysts that defendants' misstatements did not cause any distortion in the price of the stock.

that investor was not personally aware of the curative disclosure. *Rodman v. Grant Foundation*, 460 F. Supp. 1028, 1036 (S.D.N.Y. 1978), *aff'd*, 608 F.2d 64 (2d Cir. 1979) (disclosure in annual report cures omission in proxy statement); *United Canso Oil & Gas Ltd. v. Clark*, 497 F. Supp. 111, 115 (S.D.N.Y. 1980) (proxy statement cured by newspaper advertisement of other proxy contestant); *In re Memorex Security Cases*, 61 F.R.D. 88, 97 (N.D. Cal. 1973) (class does not include anyone who bought after date of correcting announcement). The theory of that defense is that the market price reflected the curative information and thus that the investor was not injured even if he actually relied upon the prior misstatement. It is disingenuous for these securities-defense groups now to urge the Court to ignore market efficiency only when it works to their detriment.

B. Petitioners And Their Supporting Amici Mischaracterize The True Nature And Impact Of The Fraud-On-The-Market Doctrine.

Contrary to the arguments of several opposing amici, the fraud-on-the-market doctrine does not dispense with proof of causation or damage. Plaintiffs have the burden of alleging and proving, *inter alia*, that misrepresentations made by defendants were material, that the stock was traded on an efficient market and therefore the misinformation influenced the trading price, that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the stock, and that plaintiffs traded in the stock between the time the misrepresentations were made and the time the truth was revealed (*see* requirements set forth in the Sixth Circuit opinion below, 786 F.2d at 750).

Furthermore, plaintiffs regularly introduce evidence concerning the *amount* by which the market price of the securities was inflated or deflated with respect to its true value as a result of defendants' misleading statements. Proof

of the amount of damage constitutes affirmative proof by plaintiffs that the market price was in fact distorted by the materially misleading representations, and that injury was caused to the plaintiffs by those misleading statements.

It must be stressed that the presumption of reliance is rebuttable. As stated by the Sixth Circuit below, defendant can rebut proof of the five elements that give rise to the presumption. It can also disprove the presumed facts by showing that an insufficient number of traders relied to distort the price or can show that an individual plaintiff traded or would have traded despite knowledge of the falsity of the representation. *Levinson*, 786 F.2d at 750 n.6. Counsel for the Investor *Amici* know from their own experience that on occasion defendants in securities cases have succeeded, during cross examination, in casting doubt on whether plaintiffs actually would have relied on the facts which were concealed, and have often introduced expert testimony that the price action of the security involved was inconsistent with a conclusion that the market price had been influenced by the alleged deception. Furthermore, defendants have been successful at trial on the ground that defendants' material omissions were harmless because the information was made known to the plaintiff class members from other sources. See, e.g., *Spelman v. General Host Corp.*, 538 F.2d 39 (2d Cir. 1976).

Thus, if defendants can demonstrate in the instant case that leaks, rumors or assumptions caused the market fully to anticipate the bid for petitioner Basic, see ACCA *Amicus* Br., pp. 3, 10, the jury will find no liability. See *Polin v. Conductron Corp.*, 411 F. Supp. 698, 703 (E.D. Mo. 1976), *aff'd*, 552 F.2d 797 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977). Alternatively, it will find no damages, since Rule 10b-5 damages are most typically arrived at by taking the difference between market price and "true val-

ue" at the time of purchase or sale assuming proper disclosures. E.g., *Green v. Occidental Petroleum*, 541 F.2d 1335, 1344 (9th Cir. 1976) (Sneed J., concurring). Here, again, defendants can take full advantage of "efficient market" defenses.

Causation and damage issues are addressed in every Section 10(b) trial by expert witnesses trained in economics and finance and highly experienced in the operations of the securities markets. These experts study the public disclosures regarding the issues in controversy and the price movements of the security involved, and draw conclusions as to whether the plaintiff class has in fact been harmed by the alleged misstatements or omissions. Thus, in actual practice, the evidence in fraud-on-the-market cases includes proof that the price at which plaintiff bought or sold was distorted as a result of defendants' fraud.

The *amici* supporting petitioners argue against a presumption of reliance on the ground that different investors will place different degrees of reliance on material misstatements, depending on their own particular circumstances and the other information which comes to their attention. Even if that is so, the causal relationship between the deception and the injury exists with respect to all investors who purchase while the deception affects the market price. Regardless of the precise significance different investors would have placed upon the same set of material misstatements, the reactions of various investors have one overall distorting effect upon the market price of the securities. All investors who relied upon the integrity of the market price were injured because they bought shares which had been inflated in price by the material misrepresentations.

C. The Structure Of The Securities Laws And The Legislative History Is Fully Consistent With The Fraud-on-The-Market Doctrine.

Petitioners and their supporting *amici* err in arguing that the structure of the securities laws shows an intent by Congress to require individual reliance on the specific misrepresentations at issue. Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, contains no reliance requirement unless the deceptive prospectus is superseded by an earnings statement covering a period of at least twelve months post-dating the prospectus.⁶ The one limited situation where Section 11 does contain a reliance requirement actually supports the fraud-on-the-market doctrine, since it requires proof of reliance *only* when the prospectus is more than a year out of date. Moreover, that provision states that "such reliance may be established without proof of the reading of the registration statement by such person"—a provision that looks toward flexibility in the application of the reliance requirement.

Ironically, the argument of *amicus* American Institute of Certified Public Accountants ("AICPA") concerning Section 9 of the Exchange Act supports the respondents' position. Quoting Professor Loss, the AICPA states:

Although Section 9(e) does not specifically refer to reliance,

[I]t contains a causation requirement which is probably stricter than the burden the plaintiff would face in a common law deceit action based on the defendant's manipulation: Not only are damages limited to those "sustained as a result" of the manipulation; the plaintiff must also show

⁶ This Court has recognized that under Section 11, "if a plaintiff purchased a security issued pursuant to the registration statement, he need only show a material misstatement or omission to establish his *prima facie* case." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983).

that he bought or sold "at a price which was affected by" the manipulation.

3 L. Loss, *Securities Regulation* 1748 (2d ed. 1961). (footnote omitted). (AICPA Br., pp. 11-12).

However, this is the same burden of proof a plaintiff satisfies in cases involving the fraud-on-the-market doctrine. In trials of those cases, plaintiffs offer expert testimony that the material misrepresentation distorted the market price of the securities, thereby proving that plaintiffs bought or sold at a price which was affected by the misrepresentation.

Nor should the fraud-on-the-market theory be rejected because Section 18(a) of the 1934 Act contains a reliance requirement. In *Herman & MacLean v. Huddleston*, this Court held that a cause of action under Section 10(b) will lie for conduct also subject to an express civil remedy under Section 11 of the 1933 Act. In so holding, the Court stressed that Section 11 and Section 10(b) addressed different types of wrongdoing and that, in particular, Section 10(b) required *scienter* whereas Section 11 did not. Similarly, Section 18 does not require *scienter*. Consequently, its provisions do not govern the criteria for relief under Section 10(b). *E.g.*, *Wachovia Bank & Trust Co., N.A. v. National Student Marketing Corp.*, 650 F.2d 342, 357 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981); *Ross v. A.H. Robins Co., Inc.*, 607 F.2d 545, 552-53 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

The legislative history with respect to Section 10(b) provides no support for petitioners and their *amici*. The material on which they rely deals with Section 18 rather than the broader provisions of Section 10(b). Furthermore, as stated in *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985), the legislative history is supportive of the fraud-on-the-market doctrine:

Nor do we find, as the defendants argue, that the legislative history of the Securities Exchange Act of 1934 necessitates a different conclusion because Congress intended to make reliance on the misleading statements a prerequisite for recovery. The fraud-on-the-market theory as articulated in *Blackie* does not eliminate the need for the plaintiff to show reliance; it simply recognizes that reliance may be presumed where securities are traded on the open market, subject to the defendant proving that the misrepresentations were not material or that the plaintiff's decision to purchase was or would have been unaffected if he had known the true facts. *Blackie*, 524 F.2d at 906. The theory thus actually facilitates Congress' intent in enacting the federal securities law by enabling a purchaser to rely on an expectation that the securities markets are free from fraud. *Id.* at 907. (footnote omitted).

Id. at 747-48.

Finally, any other interpretation would make federal securities protection little different from that in a common law fraud case. In *Herman & McLean v. Huddleston*, this Court stated:

[T]he antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry.

459 U.S. at 388-89 (footnote and citation omitted).⁷

⁷ Indeed, "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744-45 (1975).

D. The Fraud-On-The-Market Doctrine Reflects Long Standing Judicial Recognition That The Reliance Requirement Should Be Interpreted Flexibly, To Facilitate Private Enforcement Of The Securities Laws.

The fraud-on-the-market doctrine did not spring to life out of a vacuum. Rather, it was a reflection of years of prior experience of federal courts in interpreting the judicially created reliance requirement in Section 10(b) cases. Well before the fraud-on-the-market doctrine was specifically articulated, the federal courts routinely held that the reliance requirement did not create a predominance of individual issues which would block class certification. *See, e.g., Mader v. Armel*, 402 F.2d 158, 162-63 (6th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969); *Harris v. Palm Springs Alpine Estates*, 329 F.2d 909, 914 (9th Cir. 1964); *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369, 375 (D. Del. 1965); *Korn v. Franchard Corp.*, 456 F.2d 1206, 1212-13 (2d Cir. 1972) ("The existence and materiality of these misrepresentations undoubtedly present significant common questions. . . . In fraud or 10b-5 cases decided in recent years, various rules, mechanisms, or presumptions have been put forward for mitigating the problem of showing reliance . . ."). (footnotes omitted).

The approach to the reliance requirement taken in such cases and in the subsequent opinions articulating the fraud-on-the-market doctrine comports with this Court's recognition that "securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.'" *Herman & MacLean v. Huddleston*, 459 U.S. at 386-87 (citation omitted) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)); *Bateman, Eichler, Hill Richards v. Berner*, 472 U.S. 299, 105 S.Ct. 2622, 2628-29 (1985).

The fraud-on-the-market doctrine and its predecessor decisions with respect to reliance embody and advance the Congressional policy of encouraging private enforcement of the securities laws. As stated by this Court in *Bateman Eichler, Hill Richards, Inc. v. Berner*,

Moreover, we repeatedly have emphasized that implied private actions provide "a most effective weapon in the enforcement" of the securities laws and are "a necessary supplement to Commission action." *J.I. Case Co. v. Borak*, 377 U.S. 426, 432, 84 S.Ct. 1555, 1560, 12 L. Ed.2d 423 (1964); see also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730, 95 S.Ct. 1917, 1922, 44 L. Ed.2d 539 (1975).

— U.S. at —, 105 S.Ct. at 2628.

E. The Fraud-On-The-Market Doctrine Serves A Valuable Function In Facilitating Efforts To Achieve Meaningful Relief For Defrauded Investors Through Securities Class Actions.

The arguments of petitioners and their supporting *amici* represent a concerted effort to undercut the viability of all securities class actions. In light of the importance of investor class actions to enforcement of the securities laws, those arguments should be rejected.

The fraud-on-the-market doctrine has played a particularly important role in the class context, since it is one approach which the courts have used in concluding that the reliance requirement does not typically create a preponderance of individual issues under Section 10(b). This function of the doctrine is crucially important, since, as stated by Professor Loss, "the ultimate effectiveness of the federal [securities] remedies . . . may depend in large measure on the applicability of the class action device."

3 L. Loss, *Securities Regulation*, 1819 (2d ed. 1961). (footnote omitted).

In a different context, this Court has recently recognized that one goal of the modern plaintiff class action is to "permit the plaintiffs to pool claims which would be uneconomical to litigate individually." *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 809 (1985). Investor class actions perform precisely that function in the context of securities fraud. As stated in *Escott v. Barchris Construction Corp.*, 340 F.2d 731, 733 (2d Cir. 1965):

In our complex modern economic system where a single harmful act may result in damages to a great many people there is a particular need for the representative action as a device for vindicating claims which, taken individually, are too small to justify legal action but which are of significant size if taken as a group. In a situation where we depend on individual initiative, particularly the initiative of lawyers, for the assertion of rights, there must be a practical method for combining these small claims, and the representative action provides that method. The holders of one or two of the debentures involved in the present action could hardly afford to take the risk of an individual action. The usefulness of the representative action as a device for the aggregation of small claims is "persuasive of the necessity of a liberal construction of * * * Rule 23." *Weeks v. Bareco Oil Co.*, 125 F.2d 84 (7th Cir. 1941); and see generally Kalven and Rosenfield, *The Contemporary Function of the Class Suit*, 8 Univ. of Chi.L.Rev. 684 (1941). (footnote omitted).

Consistent with this view, the courts have repeatedly recognized the utility of, and the necessity for, class actions in securities litigation.⁴

Petitioners' supporting *amici* devote considerable energy to an attack upon the securities class action, claiming that the *in terrorem* effect of class certification compels defendants to settle those cases without regard to their merit. In actual practice, however, defendants can and do evaluate the strength of class claims and are quite willing to take them to trial if they believe their defense is sound. See, e.g., *Flamm v. Eberstadt*, 814 F.2d 1169 (7th Cir. 1987); *Radol v. Thomas*, 772 F.2d 244 (6th Cir. 1985), *cert. denied*, — U.S. —, 106 S.Ct. 3272 (1986); *Flynn v. Bass Brothers Enterprises, Inc.*, 744 F.2d 978 (3rd Cir. 1984); *Spelman v. General Host Corp.*, 538 F.2d 39 (2d Cir. 1976). In each of those cases, defendants went to trial on class claims that involved enormous potential liability, and were successful at trial.⁵ Similarly, defendants in class actions

⁴ E.g., *Herbst v. Int'l Telephone & Telegraph Corp.*, 495 F.2d 1308 (2d Cir. 1974); *King v. Kansas City Southern Industries Inc.*, 519 F.2d 20, 26 (7th Cir. 1975); *Esplin v. Hirschi*, 402 F.2d 94, 101 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969); *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970); *Grossman v. Waste Management, Inc.*, 100 F.R.D. 781 (N.D. Ill. 1984); *Dura-Bilt Corp. v. Chase Manhattan Corp.*, 89 F.R.D. 87 (S.D.N.Y. 1981).

⁵ In other trials, class plaintiffs have been successful. E.g., *In re Viatron Computers Systems Corporation Litigation*, MDL No. 138-T (D. Mass. March 24, 1981), in which class plaintiffs obtained a verdict of liability against Arthur Andersen & Co. under Section 10(b) of the Exchange Act and under Section 11 of the Securities Act of 1933, after which the case was settled before a verdict was rendered with respect to damages; *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566 (2d Cir.), *cert. denied*, 459 U.S. 838 (1982); *In re Data Point Securities Litigation*, 8A 82-CA 338 (W.D. Tex.) (Trial held in 1986); *Backman v. Polaroid Corp.*, 540 F. Supp. 667 (D. Mass. 1982) (on motion to dismiss and class certification motion) (Trial held in 1987).

have been actively making—and to some extent winning—motions for summary judgment in class actions, emphasizing in those motions recent opinions of this Court such as *Celotex Corp. v. Catrett*, — U.S. —, 106 S.Ct. 2548 (1986).

Contrary to the assertions of *amicus* AICPA (AICPA Br., p. 5), there is no "proliferation" of securities class actions resulting from the fraud-on-the-market doctrine. Statistics from the U.S. Administration Office of the Courts reflect the following numbers of securities class actions filed:

1973 — 235	1980 — 87
1974 — 305	1981 — 86
1975 — 258	1982 — 151
1976 — 212	1983 — 133
1977 — 176	1984 — 149
1978 — 167	1985 — 140
1979 — 100	1986 — 118

Class Action Reports, 1st Quarter 1987, p. 1.

Since the number of securities actions has declined significantly since the first Circuit Court articulation of the fraud-on-the-market theory in 1975, that doctrine has not been responsible for spawning the mythical "new class of plaintiffs" deplored by petitioners' supporting *amici* (see AICPA Br., p. 26). The fraud-on-the-market doctrine has plainly not generated any crisis in this field whatsoever.

Finally, in light of the narrowing of private rights of action under the federal securities laws in recent years,¹⁹

¹⁹ E.g., *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); *TransAmerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11 (1979); *In re Washington Public Power Supply System Securities Litigation*, [Current] Fed. Sec. L. Rep. * 93,330 (9th Cir. 1987) (overruling prior decisions of that court that a private right of action exists under section 17(a) of the Securities Act of 1933).

Section 10(b) stands out increasingly as the critical provision affording investors redress against a broad range of fraudulent schemes. Against this background, it is vital that this Court maintain the continued practical viability of Section 10(b) by affirming the fraud-on-the-market doctrine.

F. The Extraneous Issues Raised By Petitioners And Supporting Amici Provide No Ground For Departure From The Overwhelming Judicial Acceptance Of The Fraud-On-The-Market Doctrine.

Rather than limit themselves to the rationale for the fraud-on-the-market doctrine, petitioners and their supporting amici have utilized the opportunity for an *amicus* brief to bring arguments before the Court which have no relevance to the propriety of the fraud-on-the-market doctrine.

For example, the "Big Eight" auditing firms and the AICPA contend that the fraud-on-the-market doctrine should be rejected because auditors should not be subject to classwide liability in actions under Section 10(b). First, the fraud-on-the-market doctrine is vital not only to claims against auditors, but also to claims against stock-issuing companies, their officers and directors, and their investment bankers, all of whom participate in public statements which materially affect the decisions of investors. Second, this Court has already recognized the vital public responsibility assumed by an auditor in certifying the financial statements of public companies. In *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984), the Court stated:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function

owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. (Emphasis in original).

There is strong ground for belief that in all too many instances, auditors are not performing their responsibilities and that investors who rely on "clean" audit opinions are injured as a result. For example, a study prepared by the staff of the Subcommittee on Reports, Accounting and Management of the Committee on Government Operations of the United States Senate entitled Subcommittee on Reports, Accounting and Management of the Committee on Government Operations of the United States Senate, *The Accounting Establishment*, 94th Cong., 2d Sess., p. 7 (December 1976) stated, *inter alia*:

Serious questions have been raised concerning the independence and competence of the "Big Eight" accounting firms and other independent auditors. Those questions have arisen because of accounting and auditing problems involved in the Penn Central collapse, the Equity Funding fraud, improper and illegal activities by Gulf Oil Corp. and Northrop Corp., and the many other abuses by corporations which have come to public attention in recent years.

The large auditing firms whose voice is being heard in two of the three *amicus* briefs supporting petitioners have reaped enormous financial benefits from their activities as auditors of large public corporations.¹¹ They receive large

¹¹ In fiscal 1982, the Big Eight accounting firms collected fees aggregating over \$4.3 billion. *Public Accounting Report*, May 1983, p. 1. Recent reports indicate that on an international basis, the Big Eight are grossing well in excess of \$12 billion.

fees precisely because the imprimatur of a "clean" audit opinion is required to satisfy the investors and creditors of their client corporations. Where they intentionally, willfully, or recklessly issue a materially deceptive audit report on which they know the investing public will rely, they should be held accountable under Section 10(b).

A further example of the extent to which petitioners' supporting amici depart from the issues properly before this Court can be seen in their revolutionary assertion that persons making materially deceptive statements should not be liable unless they actively traded in the security, and then should be liable only to the extent of their gains on such transactions. *ACCA Br.*, p. 11, *et seq.* This argument raises issues which go far beyond the propriety of the fraud-on-the-market doctrine, and should be rejected or disregarded. The cases are legion that one may recover damages under Section 10 for deception which causes a purchase or sale at a distorted price regardless of whether the person issuing the deceptive statement was trading in the stock.¹¹ When corporate officers or auditors have intentionally, willfully, or recklessly issued materially deceptive reports or releases, there is no sound reason not to hold them responsible for the injuries they have caused, simply because they themselves earn no profit. They understand well that those reports and releases may affect millions of dollars in securities transactions. They, not the innocent investor, should suffer the consequences of their

¹¹ *E.g.*, *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 102 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Herpich v. Wallace*, 430 F.2d 792, 808 (5th Cir. 1970); *Heit v. Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *SEC v. American Beryllium & Oil Corp.*, 303 F. Supp. 912, 919 n.11 (S.D.N.Y. 1969); *Dienstag v. Bronsen*, [1967-1969 Tr. Binder] (CCH) Fed. Sec. L. Rep. ¶ 92,274 at 97,317 (S.D.N.Y. Sept. 26, 1968).

wrong. Furthermore, limiting the remedy to disgorgement of profit would undermine the deterrent purpose of the private right of action under the federal securities laws, since the fraudulent party is at risk only to the extent of returning his illicit profit.

Notwithstanding such considerations, however, the proper measure of damages in a Section 10(b) action is a subject totally independent of the merits of the fraud-on-the-market doctrine, and deserves no consideration by the Court in this case.

II.

The Writ Should Be Dismissed As Improvidently Granted With Regard To The Fraud-On-The-Market Issue.

Investor Amici urge this Court to dismiss the writ as improvidently granted because this is the wrong case in which to examine fraud-on-the-market principles. The reasons are several.

First, Investor Amici do not believe that there is any occasion for examining this issue, in light of the unanimous approval of the fraud-on-the-market doctrine accorded by the Courts of Appeal, the SEC and the commentators.

Second, there is no final judgment before the Court presenting the issue squarely. What is before the Court is affirmance of a class certification, normally not even an appealable order. *See Coopers & Lybrand v. Livesay*, 437 U.S. 463 (1978). Moreover, class certifications, even when properly appealable, are reviewed only for abuse of discretion. *E.g.*, *In re Cement & Concrete Antitrust Litigation*, 817 F.2d 1435, 1443 (9th Cir. 1987); *Wright v. Stone Container Corp.*, 524 F.2d 1058, 1061 (8th Cir. 1975). Since at trial defendants are free to rebut proof of any of the

five elements giving rise to the presumption of reliance and can also disapprove the presumed reliance in the manner described by the Sixth Circuit (*see* 786 F.2d at 750 n.6), the fraud-on-the-market doctrine may not be determinative of the outcome in this action.

In fact, acceptance of the fraud-on-the-market doctrine was not even dispositive of the class certification issue. The class could have been certified without reference to that doctrine, for example, on the ground that the public statements were materially misleading not because of an affirmative misstatement, but because of the omission to disclose the existence and status of merger negotiations.¹³ Seen in this light, the case would fall directly within this Court's ruling in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-54 (1972), and proof of reliance would be unnecessary.

Thus, the Court is being asked, without benefit of a final judgment, to opine on a factual presumption which may well not govern the result in this case. There will be time enough to review the fraud-on-the-market concept when it is presented concretely in a case where recovery has been granted based upon acceptance of the theory or denied based on its rejection.

Third, this case presents the claims of defrauded sellers, while the overwhelming majority of fraud-on-the-market cases involve purchasers. Indeed, petitioners urge that

¹³ Petitioners argue that they made no misrepresentation when they told the investing public that they did not know of any corporate developments which would account for the unusual trading in their stock. Even if they did not, in fact, know that the unusual trading was stimulated by inside information concerning merger negotiations, the statements may still be held deceptive on the ground that the failure to mention the merger negotiations was misleading. Based on that theory, this case would involve deceptive omissions, rather than affirmative misrepresentations.

sellers are less worthy of the presumption of reliance than purchasers. Petitioners Br., pp. 43-44. They also argue that a 14-month class period is excessive. *Id.* at 42-43. Without conceding either proposition, it is nevertheless clear that the law governing the claims of sellers is far less developed than that of purchasers, and that petitioners and supporting *amici* themselves contend that the fact pattern here is not squarely within the mainstream of fraud-on-the-market cases. The Court should avoid these special aspects of this case and await a more typical fraud-on-the-market action.

Finally, there is the distraction presented by the issue concerning the materiality of merger negotiations. Respondents and the SEC have concentrated principally upon that issue rather than the fraud-on-the-market doctrine. If the Court wishes to address the fraud-on-the-market concept, Investor *Amici* respectfully submit that it should do so in a case in which the attention of the parties will be focused fully upon that issue. The fraud-on-the-market doctrine is an extremely important concept currently being applied in numerous cases pending in courts across the country, and should not be reviewed by this Court unless the parties are treating that issue as the central question before the Court.

CONCLUSION

The writ should be dismissed on the fraud-on-the-market issue, or the decision below affirmed on the class certification question as within the discretion of the District Court.

Respectfully submitted,

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